

WATERS CORP /DE/  
Form 10-Q  
November 03, 2017

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**Form 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the quarterly period ended September 30, 2017**

**or**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission File Number: 01-14010**

**Waters Corporation**

**(Exact name of registrant as specified in its charter)**

**Delaware**  
**(State or other jurisdiction of**  
**incorporation or organization)**

**13-3668640**  
**(I.R.S. Employer**  
**Identification No.)**

**34 Maple Street**

**Milford, Massachusetts 01757**

**(Address, including zip code, of principal executive offices)**

**(508) 478-2000**

**(Registrant's telephone number, including area code)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of large accelerated filer, accelerated filer, smaller reporting company and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if smaller reporting company)

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

Indicate the number of shares outstanding of the registrant's common stock as of October 27, 2017: 79,533,016



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**WATERS CORPORATION AND SUBSIDIARIES**

**QUARTERLY REPORT ON FORM 10-Q**

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**WATERS CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(IN THOUSANDS, EXCEPT PER SHARE DATA)****(unaudited)**

|   | <b>September 30, 2017</b> | <b>December 31, 2016</b> |
|---|---------------------------|--------------------------|
| <b>ASSETS</b>   |                           |                          |
| Current assets:   |                           |                          |
| Cash and cash equivalents   | \$ 603,807                | \$ 505,631               |
| Investments   | 2,651,150                 | 2,307,401                |
| Accounts receivable, less allowances for doubtful accounts and sales returns of \$9,379 and \$8,657 at September 30, 2017 and December 31, 2016, respectively | 456,334                   | 489,340                  |
| Inventories   | 297,854                   | 262,682                  |
| Other current assets  | 69,380                    | 70,391                   |
| Total current assets  | 4,078,525                 | 3,635,445                |
| Property, plant and equipment, net  | 342,832                   | 337,118                  |
| Intangible assets, net  | 224,056                   | 207,055                  |
| Goodwill  | 359,376                   | 352,080                  |
| Other assets  | 158,196                   | 130,361                  |
| Total assets  | \$ 5,162,985              | \$ 4,662,059             |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                           |                          |
| Current liabilities:  |                           |                          |
| Notes payable and debt  | \$ 225,423                | \$ 125,297               |
| Accounts payable  | 66,754                    | 67,740                   |
| Accrued employee compensation   | 42,021                    | 57,465                   |
| Deferred revenue and customer advances  | 185,524                   | 148,837                  |
| Accrued income taxes  | 24,355                    | 15,244                   |
| Accrued warranty  | 12,855                    | 13,391                   |
| Other current liabilities   | 105,217                   | 92,347                   |
| Total current liabilities   | 662,149                   | 520,321                  |
| Long-term liabilities:  |                           |                          |
| Long-term debt  | 1,732,367                 | 1,701,966                |
| Long-term portion of retirement benefits  | 69,666                    | 72,568                   |
| Long-term income tax liabilities  | 7,656                     | 10,458                   |
| Other long-term liabilities   | 62,052                    | 54,797                   |
| Total long-term liabilities   | 1,871,741                 | 1,839,789                |
| Total liabilities   | 2,533,890                 | 2,360,110                |

## Commitments and contingencies (Notes 5, 6, 7 and 11)

## Stockholders' equity:

Preferred stock, par value \$0.01 per share, 5,000 shares authorized, none issued at September 30, 2017 and December 31, 2016

Common stock, par value \$0.01 per share, 400,000 shares authorized, 159,589 and 158,634 shares issued, 79,522 and 80,023 shares outstanding at September 30, 2017 and December 31, 2016, respectively

|   |                     |                     |
|---|---------------------|---------------------|
|   | 1,596               | 1,586               |
| Additional paid-in capital  | 1,710,783           | 1,607,241           |
| Retained earnings   | 5,758,552           | 5,385,069           |
| Treasury stock, at cost, 80,067 and 78,611 shares at September 30, 2017 and December 31, 2016, respectively | (4,721,409)         | (4,475,667)         |
| Accumulated other comprehensive loss  | (120,427)           | (216,280)           |
| <b>Total stockholders' equity</b>   | <b>2,629,095</b>    | <b>2,301,949</b>    |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 5,162,985</b> | <b>\$ 4,662,059</b> |

The accompanying notes are an integral part of the interim consolidated financial statements.

**WATERS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(IN THOUSANDS, EXCEPT PER SHARE DATA)**

(unaudited)

|   | <b>Three Months Ended</b> |                        |
|---|---------------------------|------------------------|
|   | <b>September 30, 2017</b> | <b>October 1, 2016</b> |
| <b>Revenues:</b>  |                           |                        |
| Product sales   | \$ 375,550                | \$ 349,934             |
| Service sales   | 190,034                   | 176,896                |
| <b>Total net sales</b>  | <b>565,584</b>            | <b>526,830</b>         |
| <b>Costs and operating expenses:</b>                                    |                           |                        |
| Cost of product sales   | 155,621                   | 145,623                |
| Cost of service sales   | 80,271                    | 72,721                 |
| Selling and administrative expenses                                     | 135,194                   | 123,861                |
| Research and development expenses                                       | 33,782                    | 30,418                 |
| Purchased intangibles amortization                                      | 1,682                     | 2,476                  |
| <b>Total costs and operating expenses</b>                               | <b>406,550</b>            | <b>375,099</b>         |
| <b>Operating income</b>   | <b>159,034</b>            | <b>151,731</b>         |
| Interest expense  | (14,750)                  | (11,707)               |
| Interest income   | 9,516                     | 5,426                  |
| <b>Income from operations before income taxes</b>                       | <b>153,800</b>            | <b>145,450</b>         |
| Provision for income taxes  | 17,696                    | 20,594                 |
| <b>Net income</b>   | <b>\$ 136,104</b>         | <b>\$ 124,856</b>      |
| <b>Net income per basic common share</b>                                | <b>\$ 1.71</b>            | <b>\$ 1.55</b>         |
| <b>Weighted-average number of basic common shares</b>                   | <b>79,712</b>             | <b>80,677</b>          |
| <b>Net income per diluted common share</b>                              | <b>\$ 1.69</b>            | <b>\$ 1.53</b>         |
| <b>Weighted-average number of diluted common shares and equivalents</b> | <b>80,521</b>             | <b>81,388</b>          |

The accompanying notes are an integral part of the interim consolidated financial statements.

**WATERS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(IN THOUSANDS, EXCEPT PER SHARE DATA)**

(unaudited)

|   | <b>Nine Months Ended</b>  |                        |
|---|---------------------------|------------------------|
|   | <b>September 30, 2017</b> | <b>October 1, 2016</b> |
| <b>Revenues:</b>  |                           |                        |
| Product sales   | \$ 1,072,684              | \$ 1,017,478           |
| Service sales   | 549,119                   | 521,158                |
| <b>Total net sales</b>  | <b>1,621,803</b>          | <b>1,538,636</b>       |
| <b>Costs and operating expenses:</b>                                    |                           |                        |
| Cost of product sales   | 436,800                   | 419,695                |
| Cost of service sales   | 239,814                   | 220,179                |
| Selling and administrative expenses                                     | 395,908                   | 382,793                |
| Research and development expenses                                       | 97,471                    | 92,434                 |
| Litigation provisions   | 10,018                    |                        |
| Acquired in-process research and development                            | 5,000                     |                        |
| Purchased intangibles amortization                                      | 5,104                     | 7,531                  |
| <b>Total costs and operating expenses</b>                               | <b>1,190,115</b>          | <b>1,122,632</b>       |
| <b>Operating income</b>   | <b>431,688</b>            | <b>416,004</b>         |
| Interest expense  | (41,558)                  | (32,809)               |
| Interest income   | 25,229                    | 14,340                 |
| <b>Income from operations before income taxes</b>                       | <b>415,359</b>            | <b>397,535</b>         |
| Provision for income taxes  | 41,876                    | 50,410                 |
| <b>Net income</b>   | <b>\$ 373,483</b>         | <b>\$ 347,125</b>      |
| <b>Net income per basic common share</b>                                | <b>\$ 4.67</b>            | <b>\$ 4.29</b>         |
| <b>Weighted-average number of basic common shares</b>                   | <b>79,908</b>             | <b>80,923</b>          |
| <b>Net income per diluted common share</b>                              | <b>\$ 4.63</b>            | <b>\$ 4.26</b>         |
| <b>Weighted-average number of diluted common shares and equivalents</b> | <b>80,660</b>             | <b>81,573</b>          |

The accompanying notes are an integral part of the interim consolidated financial statements.



**WATERS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(IN THOUSANDS)

(unaudited)

|  | Three Months Ended    |                    | Nine Months Ended     |                    |
|--|-----------------------|--------------------|-----------------------|--------------------|
|  | September 30,<br>2017 | October 1,<br>2016 | September 30,<br>2017 | October 1,<br>2016 |
| Net income   | \$ 136,104            | \$ 124,856         | \$ 373,483            | \$ 347,125         |
| Other comprehensive income (loss):                           |                       |                    |                       |                    |
| Foreign currency translation                                 | 26,827                | 2,480              | 94,209                | (12,954)           |
| Unrealized gains (losses) on investments before income taxes | 318                   | (1,393)            | 1,700                 | 3,777              |
| Income tax (expense) benefit                                 | (9)                   | 61                 | (108)                 | (108)              |
| Unrealized gains (losses) on investments, net of tax         | 309                   | (1,332)            | 1,592                 | 3,669              |
| Retirement liability adjustment before reclassifications     | (499)                 | (183)              | (2,030)               | (682)              |
| Amounts reclassified to selling and administrative expenses  | 894                   | 832                | 2,652                 | 2,452              |
| Retirement liability adjustment before income taxes          | 395                   | 649                | 622                   | 1,770              |
| Income tax expense   | (183)                 | (272)              | (570)                 | (1,163)            |
| Retirement liability adjustment, net of tax                  | 212                   | 377                | 52                    | 607                |
| Other comprehensive income (loss)                            | 27,348                | 1,525              | 95,853                | (8,678)            |
| Comprehensive income   | \$ 163,452            | \$ 126,381         | \$ 469,336            | \$ 338,447         |

The accompanying notes are an integral part of the interim consolidated financial statements.

**WATERS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(IN THOUSANDS)

(unaudited)

|   | Nine Months Ended  |                 |
|---|--------------------|-----------------|
|   | September 30, 2017 | October 1, 2016 |
| Cash flows from operating activities:   |                    |                 |
| Net income  | \$ 373,483         | \$ 347,125      |
| Adjustments to reconcile net income to net cash provided by operating activities: |                    |                 |
| Stock-based compensation  | 30,068             | 32,604          |
| Deferred income taxes   | 3,046              | 4,924           |
| Depreciation  | 45,454             | 38,854          |
| Amortization of intangibles   | 32,795             | 33,510          |
| Excess tax benefit related to stock-based compensation plans                      |                    | 12,914          |
| Gain on sale of assets  |                    | (1,500)         |
| In-process research and development charge  | 5,000              |                 |
| Change in operating assets and liabilities, net of acquisitions:                  |                    |                 |
| Decrease in accounts receivable   | 53,358             | 39,471          |
| Increase in inventories   | (26,217)           | (39,988)        |
| Increase in other current assets  | (12,944)           | (2,906)         |
| Increase in other assets  | (2,370)            | (4,667)         |
| Decrease in accounts payable and other current liabilities                        | (23,066)           | (29,179)        |
| Increase in deferred revenue and customer advances                                | 29,332             | 29,244          |
| (Decrease) increase in other liabilities  | (2,483)            | 8,611           |
| Net cash provided by operating activities   | 505,456            | 469,017         |
| Cash flows from investing activities:   |                    |                 |
| Additions to property, plant, equipment and software capitalization               | (55,257)           | (72,296)        |
| Business acquisitions, net of cash acquired                                       |                    | (5,654)         |
| Investment in unaffiliated company  | (7,000)            |                 |
| Payments for intellectual property licenses                                       | (5,000)            |                 |
| Purchases of investments  | (2,345,259)        | (1,923,054)     |
| Maturities and sales of investments   | 2,008,528          | 1,558,330       |
| Proceeds from sale of assets  |                    | 4,000           |
| Net cash used in investing activities   | (403,988)          | (438,674)       |
| Cash flows from financing activities:   |                    |                 |
| Proceeds from debt issuances  | 130,190            | 440,177         |
| Payments on debt  | (64)               | (325,323)       |
| Payments of debt issuance costs   |                    | (1,705)         |
| Proceeds from stock plans   | 72,821             | 58,572          |

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|  |            |            |
|--|------------|------------|
| Purchases of treasury shares                                 | (245,742)  | (241,924)  |
| Proceeds from (payments for) derivative contracts            | 3,301      | (9,525)    |
| Net cash used in financing activities                        | (39,494)   | (79,728)   |
| Effect of exchange rate changes on cash and cash equivalents | 36,202     | (8,071)    |
| Increase (decrease) in cash and cash equivalents             | 98,176     | (57,456)   |
| Cash and cash equivalents at beginning of period             | 505,631    | 487,665    |
| Cash and cash equivalents at end of period                   | \$ 603,807 | \$ 430,209 |

The accompanying notes are an integral part of the interim consolidated financial statements.

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**WATERS CORPORATION AND SUBSIDIARIES**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1 Basis of Presentation and Summary of Significant Accounting Policies**

Waters Corporation (the Company) is a specialty measurement company that has pioneered chromatography, mass spectrometry and thermal analysis innovations serving the life, materials and food sciences for nearly 60 years. The Company primarily designs, manufactures, sells and services high performance liquid chromatography (HPLC), ultra performance liquid chromatography (UPLC®) and together with HPLC, referred to as LC) and mass spectrometry (MS) technology systems and support products, including chromatography columns, other consumable products and comprehensive post-warranty service plans. These systems are complementary products that are frequently employed together (LC-MS) and sold as integrated instrument systems using a common software platform. LC is a standard technique and is utilized in a broad range of industries to detect, identify, monitor and measure the chemical, physical and biological composition of materials, and to purify a full range of compounds. MS instruments are used in drug discovery and development, including clinical trial testing, the analysis of proteins in disease processes (known as proteomics), nutritional safety analysis and environmental testing. LC-MS instruments combine a liquid phase sample introduction and separation system with mass spectrometric compound identification and quantification. In addition, the Company designs, manufactures, sells and services thermal analysis, rheometry and calorimetry instruments through its TA® product line. These instruments are used in predicting the suitability and stability of fine chemicals, pharmaceuticals, water, polymers, metals and viscous liquids for various industrial, consumer goods and healthcare products, as well as for life science research. The Company is also a developer and supplier of software-based products that interface with the Company's instruments, as well as other suppliers' instruments, and are typically purchased by customers as part of the instrument system.

The Company's interim fiscal quarter typically ends on the thirteenth Saturday of each quarter. Since the Company's fiscal year end is December 31, the first and fourth fiscal quarters may have more or less than thirteen complete weeks. The Company's third fiscal quarters for 2017 and 2016 ended on September 30, 2017 and October 1, 2016, respectively.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with the instructions to the Quarterly Report on Form 10-Q and do not include all of the information and footnote disclosures required by generally accepted accounting principles (GAAP) in the United States of America. The consolidated financial statements include the accounts of the Company and its subsidiaries, which are wholly owned. All inter-company balances and transactions have been eliminated.

The preparation of consolidated financial statements in conformity with GAAP requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities at the dates of the financial statements. Actual amounts may differ from these estimates under different assumptions or conditions.

It is management's opinion that the accompanying interim consolidated financial statements reflect all adjustments (which are normal and recurring) that are necessary for a fair statement of the results for the interim periods. The interim consolidated financial statements should be read in conjunction with the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the U.S. Securities and Exchange Commission on February 24, 2017.

*Translation of Foreign Currencies*

For most of the Company's foreign operations, assets and liabilities are translated into U.S. dollars at exchange rates prevailing on the balance sheet date, while revenues and expenses are translated at average exchange rates prevailing during the period. Any resulting translation gains or losses are included in accumulated other comprehensive income in the consolidated balance sheets. The functional currency of each of the Company's foreign operating subsidiaries is the local currency of that particular country, except for the Company's subsidiaries in Hong Kong, Singapore and the Cayman Islands, where the underlying transactional cash flows are denominated in currencies other than the respective local currency of domicile. The functional currency of the Hong Kong, Singapore and Cayman Islands subsidiaries is the U.S. dollar, based on the respective entity's cash flows.

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)***Cash, Cash Equivalents and Investments*

Cash equivalents represent highly liquid investments, with original maturities of 90 days or less, while investments with longer maturities are classified as investments. The Company maintains cash balances in various operating accounts in excess of federally insured limits, and in foreign subsidiary accounts in currencies other than the U.S. dollar. As of September 30, 2017 and December 31, 2016, \$3,212 million out of \$3,255 million and \$2,766 million out of \$2,813 million, respectively, of the Company's total cash, cash equivalents and investments were held by foreign subsidiaries and may be subject to material tax effects on distribution to U.S. legal entities. In addition, \$337 million out of \$3,255 million and \$261 million out of \$2,813 million of cash, cash equivalents and investments were held in currencies other than the U.S. dollar at September 30, 2017 and December 31, 2016, respectively.

*Other Investments*

During the nine months ended September 30, 2017, the Company made a \$7 million investment in a developer of analytical system solutions used to make measurements, predict stability and accelerate product discovery in the routine analytic, process monitoring and quality control release processes for life science and biopharmaceutical markets. This investment was accounted for under the cost method of accounting.

*Fair Value Measurements*

In accordance with the accounting standards for fair value measurements and disclosures, certain of the Company's assets and liabilities are measured at fair value on a recurring basis as of September 30, 2017 and December 31, 2016. Fair values determined by Level 1 inputs utilize observable data, such as quoted prices in active markets. Fair values determined by Level 2 inputs utilize data points other than quoted prices in active markets that are observable either directly or indirectly. Fair values determined by Level 3 inputs utilize unobservable data points for which there is little or no market data, which require the reporting entity to develop its own assumptions.

The following table represents the Company's assets and liabilities that are measured at fair value on a recurring basis at September 30, 2017 (in thousands):

|                                       | Total at<br>September 30,<br>2017 | Quoted Prices<br>in Active<br>Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---------------------------------------|-----------------------------------|---|---|--|
| <b>Assets:</b>                        |                                   |   |   |  |
| U.S. Treasury securities              | \$ 548,010                        | \$  | \$ 548,010  | \$   |
| Foreign government securities         | 6,970                             |   | 6,970   |  |
| Corporate debt securities             | 1,884,101                         |   | 1,884,101   |  |
| Time deposits                         | 403,112                           |   | 403,112   |  |
| Equity securities                     | 147                               |   | 147   |  |
| Waters 401(k) Restoration Plan assets | 33,845                            | 33,845  |   |  |
| Foreign currency exchange contracts   | 213                               |   | 213   |  |

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|                                     |              |           |              |          |
|-------------------------------------|--------------|-----------|--------------|----------|
| Total                               | \$ 2,876,398 | \$ 33,845 | \$ 2,842,553 | \$       |
| Liabilities:                        |              |           |              |          |
| Contingent consideration            | \$ 3,017     | \$        | \$           | \$ 3,017 |
| Foreign currency exchange contracts | 63           |           | 63           |          |
| Total                               | \$ 3,080     | \$        | \$ 63        | \$ 3,017 |

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

The following table represents the Company's assets and liabilities that are measured at fair value on a recurring basis at December 31, 2016 (in thousands):

|                                       | <b>Total at<br/>December 31,<br/>2016</b> | <b>Quoted Prices<br/>in Active<br/>Markets<br/>for Identical<br/>Assets<br/>(Level 1)</b> | <b>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</b> |
|---------------------------------------|---|---|--|--|
| <b>Assets:</b>                        |   |   |  |  |
| U.S. Treasury securities              | \$ 570,313                                | \$  | \$ 570,313   | \$   |
| Foreign government securities         | 17,991                                    |   | 17,991   |  |
| Corporate debt securities             | 1,643,838                                 |   | 1,643,838  |  |
| Time deposits                         | 199,906                                   |   | 199,906  |  |
| Equity securities                     | 147                                       |   | 147  |  |
| Waters 401(k) Restoration Plan assets | 30,954                                    | 30,954  |  |  |
| Foreign currency exchange contracts   | 60  |   | 60   |  |
| <b>Total</b>                          | <b>\$ 2,463,209</b>                       | <b>\$ 30,954</b>  | <b>\$ 2,432,255</b>  | <b>\$</b>  |
| <b>Liabilities:</b>                   |   |   |  |  |
| Contingent consideration              | \$ 3,007                                  | \$  | \$   | \$ 3,007   |
| Foreign currency exchange contracts   | 730                                       |   | 730  |  |
| <b>Total</b>                          | <b>\$ 3,737</b>                           | <b>\$</b>   | <b>\$ 730</b>  | <b>\$ 3,007</b>  |

*Fair Value of 401(k) Restoration Plan Assets*

The 401(k) Restoration Plan is a nonqualified defined contribution plan and the assets were held in registered mutual funds and have been classified as Level 1. The fair values of the assets in this plan are determined through market and observable sources from daily quoted prices on nationally recognized securities exchanges.

*Fair Value of Cash Equivalents, Investment and Foreign Currency Exchange Contracts*

The fair values of the Company's cash equivalents, investments and foreign currency exchange contracts are determined through market and observable sources and have been classified as Level 2. These assets and liabilities have been initially valued at the transaction price and subsequently valued, typically utilizing third-party pricing services. The pricing services use many inputs to determine value, including reportable trades, benchmark yields, credit spreads, broker/dealer quotes, current spot rates and other industry and economic events. The Company validates the prices provided by third-party pricing services by reviewing their pricing methods and obtaining market values from other pricing sources. After completing these validation procedures, the Company did not adjust or override any fair value measurements provided by third-party pricing services as of September 30, 2017 and December 31, 2016. There were no transfers between the levels of the fair value hierarchy during the nine months ended September 30, 2017.



*Fair Value of Contingent Consideration*

The fair value of the Company's liability for contingent consideration relates to the July 2014 acquisition of Medimass Research, Development and Service Kft. and is determined using a probability-weighted discounted cash flow model, which uses significant unobservable inputs, and has been classified as Level 3. Subsequent changes in the fair value of the contingent consideration liability are recorded in the results of operations. The fair value of the contingent consideration liability associated with future earnout payments is based on several factors, including the estimated future results and a discount rate that reflects both the likelihood of achieving the estimated future results and the Company's creditworthiness. A change in any of these unobservable inputs can significantly change the fair value of the contingent consideration. Although there is no contractual limit, the fair value of future contingent consideration payments was estimated to be \$3 million at both September 30, 2017 and December 31, 2016, based on the Company's best estimate, as the earnout is based on future sales of certain products, some of which are currently in development, through 2034. There have been no changes in significant assumptions since December 31, 2016 and the change in fair value since then is primarily due to change in time value of money.

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)***Fair Value of Other Financial Instruments*

The Company's cash, accounts receivable, accounts payable and variable interest rate debt are recorded at cost, which approximates fair value due to their short-term nature. The carrying value of the Company's fixed interest rate debt was \$610 million at both September 30, 2017 and December 31, 2016. The fair value of the Company's fixed interest rate debt was estimated using discounted cash flow models, based on estimated current rates offered for similar debt under current market conditions for the Company. The fair value of the Company's fixed interest rate debt was estimated to be \$611 million and \$603 million at September 30, 2017 and December 31, 2016, respectively, using Level 2 inputs.

*Derivative Transactions*

The Company is a global company that operates in over 35 countries and, as a result, the Company's net sales, cost of sales, operating expenses and balance sheet amounts are significantly impacted by fluctuations in foreign currency exchange rates. The Company is exposed to currency price risk on foreign currency exchange rate fluctuations when it translates its non-U.S. dollar foreign subsidiaries' financial statements into U.S. dollars, and when any of the Company's subsidiaries purchase or sell products or services in a currency other than its own currency.

The Company's principal strategy in managing exposure to changes in foreign currency exchange rates is to naturally hedge the foreign-currency-denominated liabilities on the Company's balance sheet against corresponding assets of the same currency, such that any changes in liabilities due to fluctuations in foreign currency exchange rates are typically offset by corresponding changes in assets.

The Company does not specifically enter into any derivatives that hedge foreign-currency-denominated assets, liabilities or commitments on its balance sheet, other than a portion of certain third-party accounts receivable and accounts payable, and the Company's net worldwide intercompany receivables and payables, which are eliminated in consolidation. The Company periodically aggregates its net worldwide balances by currency and then enters into foreign currency exchange contracts that mature within 90 days to hedge a portion of the remaining balance to minimize some of the Company's currency price risk exposure. The foreign currency exchange contracts are not designated for hedge accounting treatment.

Principal hedged currencies include the Euro, Japanese yen, British pound, Mexican peso and Brazilian real. At September 30, 2017 and December 31, 2016, the Company held foreign currency exchange contracts with notional amounts totaling \$127 million and \$120 million, respectively.

The Company's foreign currency exchange contracts included in the consolidated balance sheets are classified as follows (in thousands):

|                           | <b>September 30, 2017</b> | <b>December 31, 2016</b> |
|---------------------------|---------------------------|--------------------------|
| Other current assets      | \$ 213                    | \$ 60                    |
| Other current liabilities | \$ 63                     | \$ 730                   |

The following is a summary of the activity included in cost of sales in the statements of operations related to the foreign currency exchange contracts (in thousands):

|  | <b>Three Months Ended</b> |                   | <b>Nine Months Ended</b> |                   |
|--|---------------------------|-------------------|--------------------------|-------------------|
|  | <b>September 30,</b>      | <b>October 1,</b> | <b>September 30,</b>     | <b>October 1,</b> |
|  | <b>2017</b>               | <b>2016</b>       | <b>2017</b>              | <b>2016</b>       |
| Realized gains (losses) on closed contracts  | \$ 2,871                  | \$ (1,994)        | \$ 3,301                 | \$ (9,525)        |
| Unrealized (losses) gains on open contracts  | (1,258)                   | 1,003             | 819                      | 11                |
| <b>Cumulative net pre-tax gains (losses)</b> | <b>\$ 1,613</b>           | <b>\$ (991)</b>   | <b>\$ 4,120</b>          | <b>\$ (9,514)</b> |

*Stockholders Equity*

In May 2017, the Company's Board of Directors authorized the Company to repurchase up to \$1 billion of its outstanding common stock over a three-year period. During the nine months ended September 30, 2017 and October 1, 2016, the Company repurchased 1.4 million and 1.8 million shares of the Company's outstanding common stock at a cost of \$238 million and \$236 million, respectively, under the May 2017 and other previously announced programs. As of September 30, 2017, the Company had purchased an aggregate of 5.5 million shares at a cost of

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

\$750 million under the May 2014 authorization, which is now completed. The Company has a total of \$885 million in remaining authorized capacity for future repurchases under the May 2017 authorization. In addition, the Company repurchased \$8 million and \$6 million of common stock related to the vesting of restricted stock units during the nine months ended September 30, 2017 and October 1, 2016, respectively. The Company believes that it has the financial flexibility to fund these share repurchases given current cash levels and debt borrowing capacity, as well as to invest in research, technology and business acquisitions to further grow the Company's sales and profits.

*Product Warranty Costs*

The Company accrues estimated product warranty costs at the time of sale, which are included in cost of sales in the consolidated statements of operations. While the Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its component suppliers, the Company's warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. The amount of the accrued warranty liability is based on historical information, such as past experience, product failure rates, number of units repaired and estimated costs of material and labor. The liability is reviewed for reasonableness at least quarterly.

The following is a summary of the activity of the Company's accrued warranty liability for the nine months ended September 30, 2017 and October 1, 2016 (in thousands):

|                             | <b>Balance at<br/>Beginning<br/>of Period</b> | <b>Accruals for<br/>Warranties</b> | <b>Settlements<br/>Made</b> | <b>Balance at<br/>End of<br/>Period</b> |
|-----------------------------|---|------------------------------------|-----------------------------|---|
| Accrued warranty liability: |   |                                    |                             |   |
| September 30, 2017          | \$ 13,391                                     | \$ 6,287                           | \$ (6,823)                  | \$ 12,855                               |
| October 1, 2016             | \$ 13,349                                     | \$ 7,101                           | \$ (6,915)                  | \$ 13,535                               |

*Restructuring and Other Charges*

During the nine months ended September 30, 2017, the Company incurred \$12 million of severance costs associated with the closure of a facility in Germany and costs associated with providing U.S. employees with an early retirement transition incentive. During the nine months ended October 1, 2016, the Company incurred \$3 million of severance costs associated with an organizational restructuring. At September 30, 2017 and December 31, 2016, the Company had \$3 million and \$2 million of severance costs accrued in other current liabilities.

*Acquired In-process Research and Development*

During the nine months ended September 30, 2017, the Company incurred a \$5 million charge for acquired in-process research and development related to a milestone payment for the licensing of certain intellectual property relating to mass spectrometry technologies yet to be commercialized and for which there was no future alternative use as of the acquisition date. This licensing arrangement is significantly related to new, biologically-focused applications, as well as other applications, and requires the Company to make additional future payments of up to \$7 million if certain milestones are achieved, as well as royalties on future net sales.



**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)****2 Marketable Securities**

The Company's marketable securities within cash equivalents and investments included in the consolidated balance sheets are detailed as follows (in thousands):

|                               | <b>September 30, 2017</b> |                            |                            |                       |
|-------------------------------|---------------------------|----------------------------|----------------------------|-----------------------|
|                               | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Gain</b> | <b>Unrealized<br/>Loss</b> | <b>Fair<br/>Value</b> |
| U.S. Treasury securities      | \$ 548,736                | \$ 91                      | \$ (817)                   | \$ 548,010            |
| Foreign government securities | 6,976                     |                            | (6)                        | 6,970                 |
| Corporate debt securities     | 1,883,688                 | 1,474                      | (1,061)                    | 1,884,101             |
| Time deposits                 | 403,113                   |                            | (1)                        | 403,112               |
| Equity securities             | 77                        | 70                         |                            | 147                   |
| <b>Total</b>                  | <b>\$ 2,842,590</b>       | <b>\$ 1,635</b>            | <b>\$ (1,885)</b>          | <b>\$ 2,842,340</b>   |
| <b>Amounts included in:</b>   |                           |                            |                            |                       |
| Cash equivalents              | \$ 191,190                | \$                         | \$                         | \$ 191,190            |
| Investments                   | 2,651,400                 | 1,635                      | (1,885)                    | 2,651,150             |
| <b>Total</b>                  | <b>\$ 2,842,590</b>       | <b>\$ 1,635</b>            | <b>\$ (1,885)</b>          | <b>\$ 2,842,340</b>   |
|                               | <b>December 31, 2016</b>  |                            |                            |                       |
|                               | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Gain</b> | <b>Unrealized<br/>Loss</b> | <b>Fair<br/>Value</b> |
| U.S. Treasury securities      | \$ 570,695                | \$ 253                     | \$ (635)                   | \$ 570,313            |
| Foreign government securities | 17,999                    |                            | (8)                        | 17,991                |
| Corporate debt securities     | 1,645,468                 | 496                        | (2,126)                    | 1,643,838             |
| Time deposits                 | 199,906                   |                            |                            | 199,906               |
| Equity securities             | 77                        | 70                         |                            | 147                   |
| <b>Total</b>                  | <b>\$ 2,434,145</b>       | <b>\$ 819</b>              | <b>\$ (2,769)</b>          | <b>\$ 2,432,195</b>   |
| <b>Amounts included in:</b>   |                           |                            |                            |                       |
| Cash equivalents              | \$ 124,793                | \$ 1                       | \$                         | \$ 124,794            |
| Investments                   | 2,309,352                 | 818                        | (2,769)                    | 2,307,401             |
| <b>Total</b>                  | <b>\$ 2,434,145</b>       | <b>\$ 819</b>              | <b>\$ (2,769)</b>          | <b>\$ 2,432,195</b>   |

The estimated fair value of marketable debt securities by maturity date is as follows (in thousands):

|  | <b>September 30, 2017</b> | <b>December 31, 2016</b> |
|--|---------------------------|--------------------------|
| Due in one year or less                | \$ 1,574,317              | \$ 1,388,537             |
| Due after one year through three years | 864,764                   | 843,605                  |
| <b>Total</b>                           | <b>\$ 2,439,081</b>       | <b>\$ 2,232,142</b>      |

### 3 Inventories

Inventories are classified as follows (in thousands):

|                          | <b>September 30, 2017</b> | <b>December 31, 2016</b> |
|--------------------------|---------------------------|--------------------------|
| Raw materials            | \$ 99,832                 | \$ 95,430                |
| Work in progress         | 20,205                    | 16,585                   |
| Finished goods           | 177,817                   | 150,667                  |
| <b>Total inventories</b> | <b>\$ 297,854</b>         | <b>\$ 262,682</b>        |

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)****4 Goodwill and Other Intangibles**

The carrying amount of goodwill was \$359 million and \$352 million at September 30, 2017 and December 31, 2016, respectively. During the nine months ended September 30, 2017, the effect of foreign currency translation increased goodwill by \$7 million.

The Company's intangible assets included in the consolidated balance sheets are detailed as follows (dollars in thousands):

|                               | September 30, 2017    |                          |                                      | December 31, 2016     |                          |                                      |
|-------------------------------|-----------------------|--------------------------|--------------------------------------|-----------------------|--------------------------|--------------------------------------|
|                               | Gross Carrying Amount | Accumulated Amortization | Weighted-Average Amortization Period | Gross Carrying Amount | Accumulated Amortization | Weighted-Average Amortization Period |
| Capitalized software          | \$ 424,155            | \$ 273,430               | 5 years                              | \$ 355,973            | \$ 223,572               | 5 years                              |
| Purchased intangibles         | 169,023               | 136,491                  | 11 years                             | 162,180               | 127,045                  | 11 years                             |
| Trademarks and IPR&D          | 13,924                |                          |                                      | 13,544                |                          |                                      |
| Licenses                      | 5,837                 | 4,502                    | 6 years                              | 4,632                 | 3,851                    | 6 years                              |
| Patents and other intangibles | 67,971                | 42,431                   | 8 years                              | 61,646                | 36,452                   | 8 years                              |
| Total                         | \$ 680,910            | \$ 456,854               | 7 years                              | \$ 597,975            | \$ 390,920               | 7 years                              |

During the nine months ended September 30, 2017, the effect of foreign currency translation increased the gross carrying value of intangible assets and accumulated amortization for intangible assets by \$52 million and \$33 million, respectively. Amortization expense for intangible assets was \$11 million and \$12 million for the three months ended September 30, 2017 and October 1, 2016, respectively. Amortization expense for intangible assets was \$33 million and \$34 million for the nine months ended September 30, 2017 and October 1, 2016, respectively. Amortization expense for intangible assets is estimated to be approximately \$44 million per year for each of the next five years.

**5 Debt**

In June 2013, the Company entered into a credit agreement that provides for a \$1.1 billion revolving facility and a \$300 million term loan facility. In April 2015, Waters Corporation entered into an amendment to this agreement (the Amended Credit Agreement). The Amended Credit Agreement provides for an increase of the revolving commitments from \$1.1 billion to \$1.3 billion and extends the maturity of the original credit agreement from June 25, 2018 until April 23, 2020. The Company plans to use future proceeds from the revolving facility for general corporate purposes.

The interest rates applicable to the Amended Credit Agreement are, at the Company's option, equal to either the alternate base rate calculated daily (which is a rate per annum equal to the greatest of (a) the prime rate in effect on such day, (b) the federal funds effective rate in effect on such day plus 1/2% per annum, or (c) the adjusted LIBO rate on such day (or if such day is not a business day, the immediately preceding business day) for a deposit in U.S. dollars with a maturity of one month plus 1% per annum) or the applicable 1, 2, 3 or 6 month adjusted LIBO rate, in each case, plus an interest rate margin based upon the Company's leverage ratio, which can range between 0 basis points to 12.5 basis points for alternate base rate loans and between 80 basis points and 117.5 basis points for adjusted LIBO



rate loans. The facility fee on the Amended Credit Agreement ranges between 7.5 basis points and 20 basis points. The Amended Credit Agreement requires that the Company comply with an interest coverage ratio test of not less than 3.50:1 as of the end of any fiscal quarter for any period of four consecutive fiscal quarters and a leverage ratio test of not more than 3.50:1 as of the end of any fiscal quarter. In addition, the Amended Credit Agreement includes negative covenants, affirmative covenants, representations and warranties and events of default that are customary for investment grade credit facilities.

At September 30, 2017, \$125 million of the outstanding portion of the revolving facility was classified as short-term liabilities in the consolidated balance sheet due to the fact that the Company expects to repay this portion of the borrowing under the revolving line of credit within the next twelve months. The remaining \$835 million of the outstanding portion of the revolving facility was classified as long-term liabilities in the consolidated balance sheet, as this portion is not expected to be repaid within the next twelve months.

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

The Company had a total of \$700 million of outstanding senior unsecured notes as of September 30, 2017 and December 31, 2016. Interest on the fixed rate senior unsecured notes is payable semi-annually each year. Interest on the floating rate senior unsecured notes is payable quarterly. The Company may prepay all or some of the senior unsecured notes at any time in an amount not less than 10% of the aggregate principal amount outstanding, plus the applicable make-whole amount or prepayment premium for Series H and J senior unsecured notes. In the event of a change in control of the Company (as defined in the note purchase agreement), the Company may be required to prepay the senior unsecured notes at a price equal to 100% of the principal amount thereof, plus accrued and unpaid interest. These senior unsecured notes require that the Company comply with an interest coverage ratio test of not less than 3.50:1 for any period of four consecutive fiscal quarters and a leverage ratio test of not more than 3.50:1 as of the end of any fiscal quarter. In addition, these senior unsecured notes include customary negative covenants, affirmative covenants, representations and warranties and events of default.

The Company had the following outstanding debt at September 30, 2017 and December 31, 2016 (in thousands):

|  | <b>September 30, 2017</b> | <b>December 31, 2016</b> |
|--|---------------------------|--------------------------|
| Foreign subsidiary lines of credit                               | \$ 423                    | \$ 297                   |
| Senior unsecured notes Series D 3.22%,<br>due March 2018         | 100,000                   |                          |
| Credit agreements  | 125,000                   | 125,000                  |
| <b>Total notes payable and debt</b>                              | <b>225,423</b>            | <b>125,297</b>           |
| Senior unsecured notes Series B 5.00%,<br>due February 2020      | 100,000                   | 100,000                  |
| Senior unsecured notes Series D 3.22%,<br>due March 2018         |                           | 100,000                  |
| Senior unsecured notes Series E 3.97%,<br>due March 2021         | 50,000                    | 50,000                   |
| Senior unsecured notes Series F 3.40%,<br>due June 2021          | 100,000                   | 100,000                  |
| Senior unsecured notes Series G 3.92%,<br>due June 2024          | 50,000                    | 50,000                   |
| Senior unsecured notes Series H floating<br>rate*, due June 2024 | 50,000                    | 50,000                   |
| Senior unsecured notes Series I 3.13%,<br>due May 2023           | 50,000                    | 50,000                   |
| Senior unsecured notes Series J floating<br>rate**, due May 2024 | 40,000                    | 40,000                   |
| Senior unsecured notes Series K 3.44%,<br>due May 2026           | 160,000                   | 160,000                  |
| Credit agreements  | 1,135,000                 | 1,005,000                |
| Unamortized debt issuance costs                                  | (2,633)                   | (3,034)                  |
| <b>Total long-term debt</b>                                      | <b>1,732,367</b>          | <b>1,701,966</b>         |

|            |    |           |    |           |
|------------|----|-----------|----|-----------|
| Total debt | \$ | 1,957,790 | \$ | 1,827,263 |
|------------|----|-----------|----|-----------|

- \* Series H senior unsecured notes bear interest at a 3-month LIBOR for that floating rate interest period plus 1.25%.
- \*\* Series J senior unsecured notes bear interest at a 3-month LIBOR for that floating rate interest period plus 1.45%. As of September 30, 2017 and December 31, 2016, the Company had a total amount available to borrow under existing credit agreements of \$338 million and \$468 million, respectively, after outstanding letters of credit. The weighted-average interest rates applicable to the senior unsecured notes and credit agreement borrowings collectively were 2.82% and 2.55% at September 30, 2017 and December 31, 2016, respectively. As of September 30, 2017, the Company was in compliance with all debt covenants.

The Company and its foreign subsidiaries also had available short-term lines of credit totaling \$90 million and \$79 million at September 30, 2017 and December 31, 2016, respectively, for the purpose of short-term borrowing and issuance of commercial guarantees. At September 30, 2017 and December 31, 2016, the weighted-average interest rates applicable to these short-term borrowings were 1.48% and 1.49%, respectively.

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)****6 Income Taxes**

The four principal jurisdictions in which the Company manufactures are the U.S., Ireland, the U.K. and Singapore, where the Company's marginal effective tax rates were approximately 37.5%, 12.5%, 19.25% and 0%, respectively, as of September 30, 2017. The Company has a contractual tax rate of 0% on qualifying activities in Singapore through March 2021, based upon the achievement of certain contractual milestones, which the Company expects to continue to meet. The current statutory tax rate in Singapore is 17%. For the first nine months of 2017 and 2016, the effect of applying the contractual tax rate rather than the statutory tax rate to income from qualifying activities in Singapore increased the Company's net income by \$18 million and \$16 million, respectively, and increased the Company's net income per diluted share by \$0.23 and \$0.20, respectively.

The Company's effective tax rate for the quarter was 11.5% and 14.2% for 2017 and 2016, respectively. Year-to-date, the Company's effective tax rate was 10.1% and 12.7% for 2017 and 2016, respectively. The decrease in the effective tax rate in 2017 as compared to 2016 can be primarily attributed to the adoption of new accounting guidance related to stock-based compensation, which decreased income tax expense by \$3 million and \$14 million for the three and nine months ended September 30, 2017, respectively, and decreased the Company's effective tax rate by 1.7 percentage points and 3.4 percentage points, respectively. See Note 13 for further information regarding the adoption of this standard. In addition, the provision for income tax for the first quarter of 2016 included a quarter-specific tax benefit associated with modifications to certain stock-based compensation awards. The remaining differences between the effective tax rate in 2017 and 2016 can be primarily attributed to differences in the proportionate amounts of pre-tax income recognized in jurisdictions with different effective tax rates.

The Company accounts for its uncertain tax return reporting positions in accordance with the accounting standards for income taxes, which require financial statement reporting of the expected future tax consequences of uncertain tax reporting positions on the presumption that all concerned tax authorities possess full knowledge of those tax reporting positions, as well as all of the pertinent facts and circumstances, but prohibit any discounting of unrecognized tax benefits associated with those reporting positions for the time value of money. The Company classifies interest and penalties related to unrecognized tax benefits as a component of the provision for income taxes.

The following is a summary of the activity of the Company's unrecognized tax benefits for the nine months ended September 30, 2017 and October 1, 2016 (in thousands):

|   | <b>September 30, 2017</b> | <b>October 1, 2016</b> |
|---|---------------------------|------------------------|
| Balance at the beginning of the period  | \$ 9,964                  | \$ 14,450              |
| Net changes in uncertain tax benefits   | (2,953)                   | (3,559)                |
| <b>Balance at the end of the period</b> | <b>\$ 7,011</b>           | <b>\$ 10,891</b>       |

With limited exceptions, the Company is no longer subject to tax audit examinations in significant jurisdictions for the years ended on or before December 31, 2012. However, carryforward tax attributes that were generated in years beginning on or before January 1, 2013 may still be adjusted upon examination by tax authorities if the attributes are utilized. The Company continuously monitors the lapsing of statutes of limitations on potential tax assessments for related changes in the measurement of unrecognized tax benefits, related net interest and penalties, and deferred tax assets and liabilities. As of September 30, 2017, the Company expects to record additional reductions in the

measurement of its unrecognized tax benefits and related net interest and penalties of approximately \$2 million within the next twelve months due to potential tax audit settlements and the lapsing of statutes of limitations on potential tax assessments. The Company does not expect to record any other material reductions in the measurement of its unrecognized tax benefits within the next twelve months.

## **7 Litigation**

From time to time, the Company and its subsidiaries are involved in various litigation matters arising in the ordinary course of business. The Company believes it has meritorious arguments in its current litigation matters and believes any outcome, either individually or in the aggregate, will not be material to the Company's financial position, results of operations or cash flows.

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

The Company has been engaged in patent litigation in Germany since 2005. In June 2017, the court issued a verdict against the Company and awarded the plaintiff damages, fees and interest. As a result of the court's judgment, the Company recorded a \$10 million provision for damages and fees estimated to be incurred in connection with this litigation. The accrued patent litigation expense of \$17 million and \$7 million is in other current liabilities in the consolidated balance sheets at September 30, 2017 and December 31, 2016, respectively.

**8 Stock-Based Compensation**

The Company maintains various shareholder-approved, stock-based compensation plans which allow for the issuance of incentive or non-qualified stock options, stock appreciation rights, restricted stock or other types of awards (e.g. restricted stock units and performance stock units). In the first quarter of 2017, the Company adopted new accounting guidance related to stock-based compensation, see Note 13 for further information regarding the adoption of this standard.

The Company accounts for stock-based compensation costs in accordance with the accounting standards for stock-based compensation, which require that all share-based payments to employees be recognized in the statements of operations based on their grant date fair values. The Company recognizes the expense using the straight-line attribution method. The stock-based compensation expense recognized in the consolidated statements of operations is based on awards that ultimately are expected to vest; therefore, the amount of expense has been reduced for estimated forfeitures. The new stock-based compensation accounting guidance offers the option of recognizing forfeitures as they occur or estimating forfeitures at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company has elected to remain consistent with prior periods and estimate forfeitures at the time of grant and, if necessary, revise in subsequent periods in which actual forfeitures differ from those estimates. Forfeitures are estimated based on historical experience. If actual results differ significantly from these estimates, stock-based compensation expense and the Company's results of operations could be materially impacted. In addition, if the Company employs different assumptions in the application of these standards, the compensation expense that the Company records in the future periods may differ significantly from what the Company has recorded in the current period.

The consolidated statements of operations for the three and nine months ended September 30, 2017 and October 1, 2016 include the following stock-based compensation expense related to stock option awards, restricted stock awards, restricted stock unit awards, performance stock unit awards and the employee stock purchase plan (in thousands):

|                                     | Three Months Ended |                 | Nine Months Ended  |                 |
|-------------------------------------|--------------------|-----------------|--------------------|-----------------|
|                                     | September 30, 2017 | October 1, 2016 | September 30, 2017 | October 1, 2016 |
| Cost of sales                       | \$ 726             | \$ 731          | \$ 2,251           | \$ 2,058        |
| Selling and administrative expenses | 10,768             | 6,944           | 25,558             | 27,526          |
| Research and development expenses   | 780                | 692             | 2,259              | 3,020           |
| Total stock-based compensation      | \$ 12,274          | \$ 8,367        | \$ 30,068          | \$ 32,604       |

During the nine months ended September 30, 2017 and October 1, 2016, the Company recognized \$4 million and \$7 million, respectively, of stock-based compensation expense related to the modification of certain stock awards upon the retirement of senior executives.

*Stock Options*

In determining the fair value of the stock options, the Company makes a variety of assumptions and estimates, including volatility measures, expected yields and expected stock option lives. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model. The Company uses implied volatility on its publicly-traded options as the basis for its estimate of expected volatility. The Company believes that implied volatility is the most appropriate indicator of expected volatility because it is generally reflective of historical volatility and expectations of how future volatility will differ from historical volatility. The expected life assumption for grants is based on historical experience for the population of non-qualified stock option exercises. The risk-free interest rate is the yield currently available on U.S. Treasury zero-coupon issues with a remaining term approximating the expected term used as the input to the Black-Scholes model. The relevant data used to determine the value of the stock options granted during the nine months ended September 30, 2017 and October 1, 2016 is as follows:

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

| <b>Options Issued and Significant Assumptions Used to Estimate Option Fair Values</b> | <b>Nine Months Ended</b>  |                        |
|---|---------------------------|------------------------|
|   | <b>September 30, 2017</b> | <b>October 1, 2016</b> |
| Options issued (in thousands)   | 217                       | 86                     |
| Risk-free interest rate   | 2.2%                      | 1.5%                   |
| Expected life in years  | 6                         | 5                      |
| Expected volatility   | 0.230                     | 0.286                  |
| Expected dividends  |                           |                        |

| <b>Weighted-Average Exercise Price and Fair Value of Options on the Date of Grant</b> | <b>Nine Months Ended</b>  |                        |
|---|---------------------------|------------------------|
|   | <b>September 30, 2017</b> | <b>October 1, 2016</b> |
| Exercise price  | \$ 151.24                 | \$ 122.65              |
| Fair value  | \$ 40.49                  | \$ 34.63               |

The following table summarizes stock option activity for the plans for the nine months ended September 30, 2017 (in thousands, except per share data):

|                                   | <b>Number of Shares</b> | <b>Price per Share</b> | <b>Weighted-Average<br/>Exercise<br/>Price per<br/>Share</b> |
|-----------------------------------|-------------------------|------------------------|--|
| Outstanding at December 31, 2016  | 2,697                   | \$ 38.09 to \$139.51   | \$ 106.55  |
| Granted                           | 217                     | \$ 136.43 to \$184.89  | \$ 151.24  |
| Exercised                         | (751)                   | \$ 41.20 to \$134.37   | \$ 90.28   |
| Canceled                          | (43)                    | \$ 87.06 to \$136.43   | \$ 115.82  |
| Outstanding at September 30, 2017 | 2,120                   | \$ 38.09 to \$184.89   | \$ 116.70  |

*Restricted Stock*

During the nine months ended September 30, 2017, the Company granted eight thousand shares of restricted stock. The weighted-average fair value per share of these awards on the grant date was \$140.52 per share.

*Restricted Stock Units*

The following table summarizes the unvested restricted stock unit award activity for the nine months ended September 30, 2017 (in thousands, except per share data):

|                               | <b>Shares</b> | <b>Weighted-Average<br/>Price per Share</b> |
|-------------------------------|---------------|---|
| Unvested at December 31, 2016 | 453           | \$ 110.34                                   |



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|                                |       |    |        |
|--------------------------------|-------|----|--------|
| Granted                        | 106   | \$ | 154.31 |
| Vested                         | (140) | \$ | 106.06 |
| Forfeited                      | (17)  | \$ | 116.83 |
| Unvested at September 30, 2017 | 402   | \$ | 123.15 |

Restricted stock units are generally granted annually in February and vest in equal annual installments over a five-year period.

*Performance Stock Units*

The Company's performance stock units are equity compensation awards with a market vesting condition based on the Company's Total Shareholder Return (TSR) relative to the TSR of the components of the S&P Health Care Index. TSR is the change in value of a stock price over time, including the reinvestment of dividends. The vesting schedule ranges from 0% to 200% of the target shares awarded.

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

In determining the fair value of the performance stock units, the Company makes a variety of assumptions and estimates, including volatility measures, expected yields and expected terms. The fair value of each performance stock unit grant was estimated on the date of grant using the Monte Carlo simulation model. The Company uses implied volatility on its publicly-traded options as the basis for its estimate of expected volatility. The Company believes that implied volatility is the most appropriate indicator of expected volatility because it is generally reflective of historical volatility and expectations of how future volatility will differ from historical volatility. The expected life assumption for grants is based on the performance period of the underlying performance stock units. The risk-free interest rate is the yield currently available on U.S. Treasury zero-coupon issues with a remaining term approximating the expected term used as the input to the Monte Carlo simulation model. The correlation coefficient is used to model the way in which each company in the S&P Health Care Index tends to move in relation to each other during the performance period. The relevant data used to determine the value of the performance stock units granted during 2017 is as follows:

| <b>Performance Stock Units Issued and Significant Assumptions Used to Estimate Fair Values</b> | <b>2017</b> |
|--|-------------|
| Performance stock units issued in thousands  | 20          |
| Risk-free interest rate  | 1.5%        |
| Expected life in years   | 3           |
| Expected volatility  | 0.232       |
| Average volatility of peer companies   | 0.261       |
| Correlation coefficient  | 0.385       |
| Expected dividends   |             |

The following table summarizes the unvested performance stock unit award activity for the nine months ended September 30, 2017 (in thousands, except per share data):

|                                | <b>Shares</b> | <b>Weighted-Average<br/>Fair Value per<br/>Share</b> |
|--------------------------------|---------------|--|
| Unvested at December 31, 2016  | 27            | \$ 171.16  |
| Granted                        | 20            | \$ 198.78  |
| Unvested at September 30, 2017 | 47            | \$ 184.40  |

**9 Earnings Per Share**

Basic and diluted earnings per share ( EPS ) calculations are detailed as follows (in thousands, except per share data):

| <b>Three Months Ended September 30, 2017</b> |   |                             |
|--|---|-----------------------------|
| <b>Net<br/>Income<br/>(Numerator)</b>        | <b>Weighted-<br/>Average Shares<br/>(Denominator)</b> | <b>Per Share<br/>Amount</b> |

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|  |            |        |         |
|--|------------|--------|---------|
| Net income per basic common share  | \$ 136,104 | 79,712 | \$ 1.71 |
| Effect of dilutive stock option, restricted stock,<br>performance stock unit and restricted stock unit<br>securities |            | 809    | (0.02)  |
| Net income per diluted common share  | \$ 136,104 | 80,521 | \$ 1.69 |

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

|  | <b>Three Months Ended October 1, 2016</b> |   |                             |
|--|---|---|-----------------------------|
|  | <b>Net<br/>Income<br/>(Numerator)</b>     | <b>Weighted-<br/>Average Shares<br/>(Denominator)</b> | <b>Per Share<br/>Amount</b> |
| Net income per basic common share  | \$ 124,856                                | 80,677  | \$ 1.55                     |
| Effect of dilutive stock option, restricted stock and restricted stock unit securities |   | 711   | (0.02)                      |
| Net income per diluted common share  | \$ 124,856                                | 81,388  | \$ 1.53                     |

|  | <b>Nine Months Ended September 30, 2017</b> |   |                             |
|--|---|---|-----------------------------|
|  | <b>Net<br/>Income<br/>(Numerator)</b>       | <b>Weighted-<br/>Average Shares<br/>(Denominator)</b> | <b>Per Share<br/>Amount</b> |
| Net income per basic common share  | \$ 373,483                                  | 79,908  | \$ 4.67                     |
| Effect of dilutive stock option, restricted stock, performance stock unit and and restricted stock unit securities |   | 752   | (0.04)                      |
| Net income per diluted common share  | \$ 373,483                                  | 80,660  | \$ 4.63                     |

|  | <b>Nine Months Ended October 1, 2016</b> |   |                             |
|--|--|---|-----------------------------|
|  | <b>Net<br/>Income<br/>(Numerator)</b>    | <b>Weighted-<br/>Average Shares<br/>(Denominator)</b> | <b>Per Share<br/>Amount</b> |
| Net income per basic common share  | \$ 347,125                               | 80,923  | \$ 4.29                     |
| Effect of dilutive stock option, restricted stock and restricted stock unit securities |  | 650   | (0.03)                      |
| Net income per diluted common share  | \$ 347,125                               | 81,573  | \$ 4.26                     |

For the three and nine months ended September 30, 2017, the Company had 0.2 million and 0.4 million stock options that were antidilutive, respectively, due to having higher exercise prices than the Company's average stock price during the period. For the three and nine months ended October 1, 2016, the Company had 0.5 million and 0.8 million stock options that were antidilutive, respectively. These securities were not included in the computation of diluted EPS. The effect of dilutive securities was calculated using the treasury stock method.

**10 Accumulated Other Comprehensive Income**

The components of accumulated other comprehensive income are detailed as follows (in thousands):

|  | <b>Currency<br/>Translation</b> | <b>Unrealized Gain<br/>(Loss) on<br/>Retirement Plans</b> | <b>Unrealized Gain<br/>(Loss) on<br/>Investments</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss)</b> |
|--|---------------------------------|---|--|--|
| Balance at December 31, 2016                     | \$ (170,566)                    | \$ (43,894)   | \$ (1,820)   | \$ (216,280)   |
| Other comprehensive income<br>(loss), net of tax | 94,209                          | 52  | 1,592  | 95,853   |
| Balance at September 30, 2017                    | \$ (76,357)                     | \$ (43,842)   | \$ (228)   | \$ (120,427)   |

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)****11 Retirement Plans**

The Company sponsors various retirement plans. The summary of the components of net periodic pension costs for the plans for the three and nine months ended September 30, 2017 and October 1, 2016 is as follows (in thousands):

|                                     | <b>Three Months Ended</b>         |   |                                       |                                   |   |                                       |
|-------------------------------------|-----------------------------------|---|---------------------------------------|-----------------------------------|---|---------------------------------------|
|                                     | <b>September 30, 2017</b>         |   |                                       | <b>October 1, 2016</b>            |   |                                       |
|                                     | <b>U.S.<br/>Pension<br/>Plans</b> | <b>U.S. Retiree<br/>Healthcare<br/>Plan</b> | <b>Non-U.S.<br/>Pension<br/>Plans</b> | <b>U.S.<br/>Pension<br/>Plans</b> | <b>U.S. Retiree<br/>Healthcare<br/>Plan</b> | <b>Non-U.S.<br/>Pension<br/>Plans</b> |
| Service cost                        | \$ 113                            | \$ 137                                      | \$ 1,311                              | \$ 94                             | \$ 116                                      | \$ 1,253                              |
| Interest cost                       | 1,707                             | 155   | 386                                   | 1,710                             | 135   | 423                                   |
| Expected return on plan assets      | (2,574)                           | (146)                                       | (434)                                 | (2,392)                           | (130)                                       | (401)                                 |
| Net amortization:                   |                                   |   |                                       |                                   |   |                                       |
| Prior service credit                |                                   |   | (47)                                  |                                   |   | (51)                                  |
| Net actuarial loss                  | 693                               |   | 248                                   | 693                               |   | 190                                   |
| Net periodic pension (benefit) cost | \$ (61)                           | \$ 146                                      | \$ 1,464                              | \$ 105                            | \$ 121                                      | \$ 1,414                              |

|                                     | <b>Nine Months Ended</b>          |   |                                       |                                   |   |                                       |
|-------------------------------------|-----------------------------------|---|---------------------------------------|-----------------------------------|---|---------------------------------------|
|                                     | <b>September 30, 2017</b>         |   |                                       | <b>October 1, 2016</b>            |   |                                       |
|                                     | <b>U.S.<br/>Pension<br/>Plans</b> | <b>U.S. Retiree<br/>Healthcare<br/>Plan</b> | <b>Non-U.S.<br/>Pension<br/>Plans</b> | <b>U.S.<br/>Pension<br/>Plans</b> | <b>U.S. Retiree<br/>Healthcare<br/>Plan</b> | <b>Non-U.S.<br/>Pension<br/>Plans</b> |
| Service cost                        | \$ 338                            | \$ 410                                      | \$ 3,802                              | \$ 282                            | \$ 348                                      | \$ 3,721                              |
| Interest cost                       | 5,122                             | 464   | 1,112                                 | 5,200                             | 405   | 1,273                                 |
| Expected return on plan assets      | (7,724)                           | (440)                                       | (1,250)                               | (7,226)                           | (390)                                       | (1,206)                               |
| Net amortization:                   |                                   |   |                                       |                                   |   |                                       |
| Prior service credit                |                                   |   | (140)                                 |                                   |   | (145)                                 |
| Net actuarial loss                  | 2,078                             |   | 714                                   | 2,027                             |   | 570                                   |
| Net periodic pension (benefit) cost | \$ (186)                          | \$ 434                                      | \$ 4,238                              | \$ 283                            | \$ 363                                      | \$ 4,213                              |

During the nine months ended September 30, 2017, the Company contributed \$4 million to the Company's U.S. pension plans. During fiscal year 2017, the Company expects to contribute a total of approximately \$6 million to \$11 million to the Company's defined benefit plans.

**12 Business Segment Information**

The Company's business activities, for which discrete financial information is available, are regularly reviewed and evaluated by the chief operating decision maker. As a result of this evaluation, the Company determined that it has

two operating segments: Waters® and TA.

The Waters operating segment is primarily in the business of designing, manufacturing, distributing and servicing LC and MS instruments, columns and other chemistry consumables that can be integrated and used along with other analytical instruments. The TA operating segment is primarily in the business of designing, manufacturing, distributing and servicing thermal analysis, rheometry and calorimetry instruments. The Company's two operating segments have similar economic characteristics; product processes; products and services; types and classes of customers; methods of distribution; and regulatory environments. Because of these similarities, the two segments have been aggregated into one reporting segment for financial statement purposes. Please refer to the consolidated financial statements for financial information regarding the one reportable segment of the Company.

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

Net sales for the Company's products and services are as follows for the three and nine months ended September 30, 2017 and October 1, 2016 (in thousands):

|                            | Three Months Ended |                   | Nine Months Ended   |                     |
|----------------------------|--------------------|-------------------|---------------------|---------------------|
|                            | September 30, 2017 | October 1, 2016   | September 30, 2017  | October 1, 2016     |
| <b>Product net sales:</b>  |                    |                   |                     |                     |
| Waters instrument systems  | \$ 238,431         | \$ 226,296        | \$ 674,768          | \$ 646,733          |
| Chemistry consumables      | 92,879             | 84,114            | 271,606             | 255,312             |
| TA instrument systems      | 44,240             | 39,524            | 126,310             | 115,433             |
| <b>Total product sales</b> | <b>375,550</b>     | <b>349,934</b>    | <b>1,072,684</b>    | <b>1,017,478</b>    |
| <b>Service net sales:</b>  |                    |                   |                     |                     |
| Waters service             | 172,594            | 160,503           | 498,736             | 471,792             |
| TA service                 | 17,440             | 16,393            | 50,383              | 49,366              |
| <b>Total service sales</b> | <b>190,034</b>     | <b>176,896</b>    | <b>549,119</b>      | <b>521,158</b>      |
| <b>Total net sales</b>     | <b>\$ 565,584</b>  | <b>\$ 526,830</b> | <b>\$ 1,621,803</b> | <b>\$ 1,538,636</b> |

**13 Recent Accounting Standard Changes and Developments***Recently Adopted Accounting Standards*

In July 2015, accounting guidance was issued which clarifies the measurement of inventory. The new guidance requires inventory to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This guidance is effective for annual and interim periods beginning after December 15, 2016. The Company adopted this standard as of January 1, 2017 and this standard did not have a material effect on the Company's financial position, results of operations and cash flows.

In March 2016, accounting guidance was issued which simplifies the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. This guidance is effective for annual and interim reporting periods beginning after December 15, 2016. The new guidance is required to be adopted on a prospective basis for the statement of operations and the Company has elected to retrospectively apply the cash flow aspects of this new guidance. In addition, the Company has elected to continue to estimate forfeitures at the time of grant and update forfeiture estimates throughout the requisite service period. The Company adopted this standard as of January 1, 2017 and recognized an excess tax benefit related to stock-based compensation which decreased income tax expense for the three and nine months ended September 30, 2017 by \$3 million and \$14 million, respectively, and added \$0.03 and \$0.18 to net income per diluted share, respectively. These excess tax benefits were previously recorded in equity and there were no cumulative-effect adjustments to retained earnings as a result of the adoption of this standard. In addition, the Company reclassified \$13 million of excess tax benefits related to stock-based compensation for the first nine months of 2016 from cash flows from financing activities to cash flows from operating activities.



*Recently Issued Accounting Standards*

In May 2014, amended accounting guidance was issued regarding the recognition of revenue from contracts with customers. The objective of this guidance is to significantly enhance comparability and clarify principles of revenue recognition practices across entities, industries, jurisdictions and capital markets. This guidance was originally effective for annual and interim reporting periods beginning after December 15, 2016; however, the Financial Accounting Standards Board ( FASB ) amended the standard in August 2015 to delay the effective period date by one year to annual and interim periods beginning after December 15, 2017. Adoption prior to December 15, 2016 is not permitted. In March 2016, the FASB clarified the implementation guidance on principal versus agent considerations and, in April 2016, clarification was made regarding certain aspects of identifying performance obligations and licensing implementation guidance. In May 2016, additional guidance was issued related to disclosure of remaining performance obligations, as well as other amendments to guidance on collectibility, non-cash consideration and the presentation of sales and other similar taxes collected from customers. The Company does not intend to early adopt this accounting standard and will apply the modified-retrospective method. Based on a preliminary analysis, the Company currently believes that the adoption of this standard will not have a material impact on the Company's financial position, results of operations and cash flows.

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**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

In January 2016, accounting guidance was issued which primarily affects the classification and measurement of certain financial instruments, principally equity investments and certain financial liabilities. Under the new guidance, there will no longer be an available-for-sale classification for equity securities with readily determinable fair values. Changes to the fair value of equity investments will be recognized through earnings. Equity investments carried at cost should be adjusted for changes in observable prices, as applicable, and qualitatively assessed for impairment annually. Changes to the fair value of financial liabilities under the fair value option due to instrument specific credit risk will be recognized separately in other comprehensive income. The new guidance also requires financial assets and financial liabilities to be presented separately and grouped by measurement category in the notes to the financial statements. This guidance is effective for annual and interim reporting periods beginning after December 15, 2017 and early adoption of certain provisions of this guidance is permitted. The Company currently does not expect that the adoption of this standard will have a material effect on the Company's financial position, results of operations and cash flows.

In February 2016, accounting guidance was issued regarding the accounting for leases. This new comprehensive lease standard amends various aspects of existing accounting guidance for leases. The core principle of the new guidance will require lessees to present the assets and liabilities that arise from leases on their balance sheets. This guidance is effective for annual and interim reporting periods beginning after December 15, 2018 and early adoption is permitted. The Company expects that the adoption of this standard will have a material effect on the Company's balance sheet classifications; however, it is not expected to have an overall material impact on the Company's results of operations and cash flows.

In June 2016, accounting guidance was issued that modifies the recognition of credit losses related to financial assets, such as debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures, and other financial assets that have the contractual right to receive cash. Current guidance requires the recognition of a credit loss when it is considered probable that a loss event has incurred. The new guidance requires the measurement of expected credit losses to be based upon relevant information, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the asset. As such, expected credit losses may be recognized sooner under the new guidance due to the broader range of information that will be required to determine credit loss estimates. The new guidance also amends the current other-than-temporary impairment model used for debt securities classified as available-for-sale. When the fair value of an available-for-sale debt security is below its amortized cost, the new guidance requires the total unrealized loss to be bifurcated into its credit and non-credit components. Any expected credit losses or subsequent recoveries will be recognized in earnings and any changes not considered credit related will continue to be recognized within other comprehensive income. This guidance is effective for annual and interim periods beginning after December 15, 2019. The Company currently does not expect that the adoption of this standard will have a material effect on the Company's financial position, results of operations and cash flows.

In August 2016, accounting guidance was issued that clarifies the classification of certain cash flows. The new guidance addresses eight specific areas where current accounting guidance is either unclear or does not specifically address classification issues. This guidance is effective for annual and interim periods beginning after December 15, 2017 and early adoption is permitted. The Company currently does not believe that the adoption of this standard will have a material impact on the Company's cash flows.

In October 2016, accounting guidance was issued regarding intra-entity transfers of assets other than inventory. The new guidance eliminates the deferral of tax effects on intra-entity transfers other than inventory and requires an entity to recognize the income tax consequences when the transfer occurs. This guidance is effective for annual and interim

periods beginning after December 15, 2017 and early adoption is permitted. The Company is currently evaluating the potential impact that the adoption of this standard will have on the Company's financial position, results of operations and cash flows.

In January 2017, accounting guidance was issued that clarifies the definition of a business. The new guidance provides a more robust framework to use in determining when a set of assets and activities is a business, thus narrowing the definition and the amount of transactions accounted for as business combinations. This guidance is effective for annual and interim periods beginning after December 15, 2017 and early application is permitted under certain circumstances. The Company will apply this guidance prospectively to any business combination transactions that take place after adoption of this new guidance.

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**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

In January 2017, accounting guidance was issued that simplifies the accounting for goodwill impairment. The guidance eliminates step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. This guidance is effective for annual and interim periods beginning after December 15, 2019 and early adoption is permitted. The Company currently does not expect that the adoption of this standard will have a material effect on the Company's financial position, results of operations and cash flows.

In March 2017, accounting guidance was issued regarding the presentation of net periodic pension cost and net periodic postretirement benefit cost. The new guidance requires that an employer disaggregate the service cost component from other components of net benefit cost, with service cost reported in the same line items as other compensation costs and the other components of net benefit costs presented outside income from operations. This guidance is effective for annual and interim periods beginning after December 15, 2017 and early adoption is permitted. The Company currently does not believe that the adoption of this standard will have a material impact on the Company's financial position, results of operations and cash flows.

In March 2017, accounting guidance was issued to amend the amortization period for certain purchased callable debt securities held at a premium. Specifically, the amortization period for certain callable debt securities will be shortened to end at the earliest call date. This guidance is effective for annual and interim periods beginning after December 15, 2018 and early adoption is permitted. The Company currently does not believe that the adoption of this standard will have a material impact on the Company's financial position, results of operations and cash flows.

In May 2017, accounting guidance was issued that clarifies the accounting for a change to the terms or conditions of a share-based payment award. The standard provides more specific guidance for determining when a change to an award requires modification accounting and when it should be deemed purely administrative in nature. This guidance is effective for annual and interim periods beginning after December 15, 2017 and early adoption is permitted. The Company currently does not believe that the adoption of this standard will have a material impact on the Company's financial position, results of operations and cash flows.

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations****Business and Financial Overview**

The Company has two operating segments: Waters® and TA®. Waters products and services primarily consist of high performance liquid chromatography ( HPLC ), ultra performance liquid chromatography ( UPLC ) and together with HPLC, referred to as LC ), mass spectrometry ( MS ) and chemistry consumable products and related services. TA products and services primarily consist of thermal analysis, rheometry and calorimetry instrument systems and service sales. The Company's products are used by pharmaceutical, biochemical, industrial, nutritional safety, environmental, academic and governmental customers. These customers use the Company's products to detect, identify, monitor and measure the chemical, physical and biological composition of materials and to predict the suitability and stability of fine chemicals, pharmaceuticals, water, polymers, metals and viscous liquids in various industrial, consumer goods and healthcare products.

The Company's operating results are as follows for the three and nine months ended September 30, 2017 and October 1, 2016 (dollars in thousands, except per share data):

|   | Three Months Ended    |                    |          | Nine Months Ended     |                    |          |
|---|-----------------------|--------------------|----------|-----------------------|--------------------|----------|
|   | September 30,<br>2017 | October 1,<br>2016 | % Change | September 30,<br>2017 | October 1,<br>2016 | % Change |
| <b>Revenues:</b>                                  |                       |                    |          |                       |                    |          |
| Product sales                                     | \$ 375,550            | \$ 349,934         | 7%       | \$ 1,072,684          | \$ 1,017,478       | 5%       |
| Service sales                                     | 190,034               | 176,896            | 7%       | 549,119               | 521,158            | 5%       |
| Total net sales                                   | 565,584               | 526,830            | 7%       | 1,621,803             | 1,538,636          | 5%       |
| <b>Costs and operating expenses:</b>              |                       |                    |          |                       |                    |          |
| Cost of sales                                     | 235,892               | 218,344            | 8%       | 676,614               | 639,874            | 6%       |
| Selling and administrative expenses               | 135,194               | 123,861            | 9%       | 395,908               | 382,793            | 3%       |
| Research and development expenses                 | 33,782                | 30,418             | 11%      | 97,471                | 92,434             | 5%       |
| Litigation provisions                             |                       |                    |          | 10,018                |                    |          |
| Acquired in-process research and development      |                       |                    |          | 5,000                 |                    |          |
| Purchased intangibles amortization                | 1,682                 | 2,476              | (32%)    | 5,104                 | 7,531              | (32%)    |
| Operating income                                  | 159,034               | 151,731            | 5%       | 431,688               | 416,004            | 4%       |
| Operating income as a % of sales                  | 28.1%                 | 28.8%              |          | 26.6%                 | 27.0%              |          |
| Interest expense, net                             | (5,234)               | (6,281)            | (17%)    | (16,329)              | (18,469)           | (12%)    |
| <b>Income from operations before income taxes</b> |                       |                    |          |                       |                    |          |
| Provision for income taxes                        | 153,800               | 145,450            | 6%       | 415,359               | 397,535            | 4%       |
| Provision for income taxes                        | 17,696                | 20,594             | (14%)    | 41,876                | 50,410             | (17%)    |
| Net income  | \$ 136,104            | \$ 124,856         | 9%       | \$ 373,483            | \$ 347,125         | 8%       |

|  |         |         |     |         |         |    |
|--|---------|---------|-----|---------|---------|----|
| Net income per diluted<br>common share | \$ 1.69 | \$ 1.53 | 10% | \$ 4.63 | \$ 4.26 | 9% |
|--|---------|---------|-----|---------|---------|----|

Sales in 2017 grew 7% and 5% for the quarter and year-to-date periods, respectively, as compared with the same periods in 2016. Foreign currency translation increased sales growth by 1% for the quarter and reduced sales growth 1% year-to-date. Sales growth was balanced across all product and customer end markets for both the quarter and year-to-date. Recent acquisitions had a minimal impact on sales growth for both the quarter and year-to-date.

In 2017, instrument systems sales grew 6% and 5% for the quarter and year-to-date, respectively, while recurring revenues (combined sales of chemistry consumables and services) grew 8% and 6%, respectively. Instrument system sales growth for both the quarter and year-to-date are attributed to an increase in customer demand for our LC-MS and TA instrument systems.

Our recurring revenues continue to benefit from a higher installed customer base, which has resulted in increased chemistry consumable and service sales. For the quarter, foreign currency translation increased both instrument system and recurring revenue sales growth by 1%. Year-to-date, foreign currency translation reduced recurring revenue sales growth by 1% and had a minimal impact on instrument systems sales growth. In addition, recurring revenues were negatively impacted by two fewer calendar days in the first nine months of 2017 as compared to the first nine months of 2016.

Geographically, sales in Europe increased 20% and 8% in 2017 for the quarter and year-to-date, respectively, on strong demand from pharmaceutical customers and the favorable effect of foreign currency translation, which increased sales growth by 7% for the quarter and reduced sales growth by 1% year-to-date. Sales in Asia grew 7% and 11% in 2017 for the quarter and year-to-date, respectively, with strong demand continuing in China for our products and services, while sales in India were negatively impacted by lower customer demand resulting from the implementation of the new Goods and Services Tax ( GST ) system.

Sales in 2017 in the U.S. increased 1% for the quarter and declined 2% year-to-date, due to lower demand from pharmaceutical customers in this market as compared to the prior year. Sales in 2017 to the rest of the world decreased 7% in the quarter and increased 1% year-to-date as these markets were somewhat negatively impacted by natural disasters in the third quarter.

The recent natural disasters in the U.S., Mexico and Puerto Rico, along with the impact of the GST system implementation in India, did not have a significant impact on our overall sales growth rates in the third quarter; however, it is unclear when the business climate in those affected areas will return to normal in the future.

In 2017, sales to pharmaceutical customers increased 7% and 6% for the quarter and year-to-date, respectively, as compared to the corresponding prior year periods, with the effect of foreign currency translation increasing sales to pharmaceutical customers by 2% for the quarter and a minimal impact year-to-date. This increase was driven by the increasing need for global access to prescription drugs and the testing of newer and more complex biologic drugs. Sales to pharmaceutical customers was negatively impacted by a decline in sales in the U.S., which we believe is the result of macroeconomic and governmental policy uncertainties as well as natural disasters experienced in the third quarter.

Combined sales to industrial customers (including sales to industrial chemical, nutritional safety and environmental customers) in 2017 increased 6% and 5% for the quarter and year-to-date, respectively, due to the increasing need for food quality and food safety testing and fine chemical applications. Combined global sales to governmental and academic customers increased 15% and 4% in 2017 for the quarter and year-to-date, respectively. Sales to governmental and academic customers are highly dependent on when institutions receive the funding to purchase our instrument systems and, as such, sales growth rates can vary significantly from quarter to quarter.

Operating income increased 5% and 4% for the quarter and year-to-date, respectively, in 2017. These increases were primarily a result of the positive effect achieved from higher sales volume and controlled spending being partially offset by a \$4 million charge related to the acceleration of certain stock awards in the third quarter of 2017. The 2017 year-to-date operating income was also impacted by \$12 million of severance costs primarily associated with the closure of a facility in Germany and costs associated with providing U.S. employees with an early retirement transition incentive. In addition, year-to-date operating income in 2017 was impacted by \$10 million of litigation settlement provisions and related costs and a \$5 million charge relating to a milestone payment for the licensing of certain intellectual property relating to mass spectrometry technologies yet to be commercialized. The change in year-to-date operating income in 2017 as compared with 2016 was also impacted by the \$7 million expense incurred in the first quarter of 2016 related to the acceleration of certain stock awards.

In the first quarter of 2017, the Company adopted a new accounting standard that requires the excess tax benefit or deficiency on stock-based compensation to be included in the statement of operations as a component of the provision for income taxes, whereas previously it was recognized in equity. As a result, the Company recorded a tax benefit on stock-based compensation in the third quarter of 2017 that decreased income tax expense by \$3 million and \$14 million for the quarter and year-to-date, respectively, and added \$0.03 and \$0.18 to net income per diluted share, respectively. Additionally, this standard required the Company to present the tax benefit in the Consolidated Statements of Cash Flows as an operating activity, whereas in the past this tax benefit was reflected as a financing activity. All prior periods presented in the cash flow have been adjusted accordingly.

The Company generated \$505 million and \$469 million of net cash flows from operations in the first nine months of 2017 and 2016, respectively. The increase in operating cash flow was primarily a result of the increase in sales and net income. Cash flows used in investing activities included capital expenditures related to property, plant, equipment and software capitalization of \$55 million and \$72 million for the first nine months of 2017 and 2016,



respectively. The 2017 cash flow from investing activities included a \$7 million payment for an investment in a developer of analytical system solutions used to make measurements, predict stability and accelerate product discovery in the routine analytic, process monitoring and quality control release processes for life science and biopharmaceutical markets. In addition, the Company made a milestone payment of \$5 million in 2017 to acquire and license intellectual property.

Within cash flows used in financing activities, the Company received \$73 million and \$59 million of proceeds from stock plans in the first nine months of 2017 and 2016, respectively. In May 2017, the Company's Board of Directors authorized the Company to repurchase up to \$1 billion of its outstanding common stock over a three-year period. The Company repurchased \$238 million and \$236 million of the Company's outstanding common stock in the first nine months of 2017 and 2016, respectively, under authorized share repurchase programs. The Company believes that it has the financial flexibility to fund these share repurchases given current cash and investment levels and debt borrowing capacity, as well as to invest in research, technology and business acquisitions to further grow the Company's sales and profits.

## Results of Operations

### Sales by Geography

Geographic sales information is presented below for the three and nine months ended September 30, 2017 and October 1, 2016 (dollars in thousands):

|                 | Three Months Ended |                 |          | Nine Months Ended  |                 |          |
|-----------------|--------------------|-----------------|----------|--------------------|-----------------|----------|
|                 | September 30, 2017 | October 1, 2016 | % change | September 30, 2017 | October 1, 2016 | % change |
| Net Sales:      |                    |                 |          |                    |                 |          |
| United States   | \$ 171,053         | \$ 168,614      | 1%       | \$ 474,661         | \$ 485,945      | (2%)     |
| Europe          | 153,232            | 128,191         | 20%      | 427,406            | 396,540         | 8%       |
| Asia:           |                    |                 |          |                    |                 |          |
| China           | 96,141             | 84,051          | 14%      | 275,367            | 234,632         | 17%      |
| Japan           | 42,202             | 42,191          |          | 125,058            | 126,305         | (1%)     |
| Asia Other      | 70,996             | 69,273          | 2%       | 219,723            | 196,399         | 12%      |
| Total Asia      | 209,339            | 195,515         | 7%       | 620,148            | 557,336         | 11%      |
| Other           | 31,960             | 34,510          | (7%)     | 99,588             | 98,815          | 1%       |
| Total net sales | \$ 565,584         | \$ 526,830      | 7%       | \$ 1,621,803       | \$ 1,538,636    | 5%       |

In the third quarter of 2017, the increase in sales in the U.S. was driven primarily by TA instrument system and service sales to industrial markets. This increase partially offset the decline experienced in the U.S. in the first half of 2017. Europe's sales growth was broad-based across all product and customer classes, with the effect of foreign currency translation increasing sales growth in 2017 by 7% for the quarter and decreasing sales growth by 1% year-to-date. China achieved strong sales growth across all product classes, which was driven by sales to pharmaceutical and industrial customers. In the third quarter of 2017, sales growth in Asia Other was impacted by customers in India delaying purchases of our products as a result of the nationwide implementation of a new GST system. Sales growth in Japan in 2017 was driven by sales to pharmaceutical, governmental and academic customers and was negatively impacted by the effect of foreign currency translation, which reduced sales growth by 9% and 4% for the quarter and year-to-date, respectively. Sales to the rest of the world were impacted by a decrease in demand

from industrial customers in the third quarter, resulting from natural disasters.

*Waters Net Sales*

Net sales for Waters products and services are as follows for the three and nine months ended September 30, 2017 and October 1, 2016 (dollars in thousands):

|                                   | <b>Three Months Ended</b>     |                       |                            |                       |                 |
|-----------------------------------|-------------------------------|-----------------------|----------------------------|-----------------------|-----------------|
|                                   | <b>September 30,<br/>2017</b> | <b>% of<br/>Total</b> | <b>October 1,<br/>2016</b> | <b>% of<br/>Total</b> | <b>% change</b> |
| Waters instrument systems         | \$ 238,431                    | 47%                   | \$ 226,296                 | 48%                   | 5%              |
| Chemistry consumables             | 92,879                        | 19%                   | 84,114                     | 18%                   | 10%             |
| <b>Total Waters product sales</b> | <b>331,310</b>                | <b>66%</b>            | <b>310,410</b>             | <b>66%</b>            | <b>7%</b>       |
| Waters service                    | 172,594                       | 34%                   | 160,503                    | 34%                   | 8%              |
| <b>Total Waters net sales</b>     | <b>\$ 503,904</b>             | <b>100%</b>           | <b>\$ 470,913</b>          | <b>100%</b>           | <b>7%</b>       |

|                                   | <b>Nine Months Ended</b>      |                       |                            |                       |                 |
|-----------------------------------|-------------------------------|-----------------------|----------------------------|-----------------------|-----------------|
|                                   | <b>September 30,<br/>2017</b> | <b>% of<br/>Total</b> | <b>October 1,<br/>2016</b> | <b>% of<br/>Total</b> | <b>% change</b> |
| Waters instrument systems         | \$ 674,768                    | 47%                   | \$ 646,733                 | 47%                   | 4%              |
| Chemistry consumables             | 271,606                       | 18%                   | 255,312                    | 19%                   | 6%              |
| <b>Total Waters product sales</b> | <b>946,374</b>                | <b>65%</b>            | <b>902,045</b>             | <b>66%</b>            | <b>5%</b>       |
| Waters service                    | 498,736                       | 35%                   | 471,792                    | 34%                   | 6%              |
| <b>Total Waters net sales</b>     | <b>\$ 1,445,110</b>           | <b>100%</b>           | <b>\$ 1,373,837</b>        | <b>100%</b>           | <b>5%</b>       |

The increase in Waters instrument system sales (LC and MS technology-based) for both the quarter and year-to-date in 2017 was primarily attributable to higher sales of LC instrument systems, as well as other LC-MS systems that incorporate the Company's tandem quadrupole technologies. Chemistry consumables sales increased on the uptake in columns and application-specific testing kits. Waters service sales benefited from increased sales of service plans and higher service demand billings to a higher installed base of customers. In total, foreign currency translation increased Waters product and service sales growth in 2017 by 1% for the quarter and reduced Waters product and service sales growth by 1% year-to-date.

In the third quarter of 2017, Waters sales in Europe increased 20% and 7% for the quarter and year-to-date, respectively, as the effect of foreign currency translation increased sales in Europe by 6% for the quarter and decreased sales by 2% year-to-date. Waters sales in Asia increased 6% and 11% for the quarter and year-to-date, respectively, and were primarily driven by China on strong demand for the Company's products and services from pharmaceutical and industrial customers. In the third quarter, Waters sales growth in India was impacted by customer ordering delays caused by the implementation of a new GST system. Waters sales in Japan were flat for the quarter and decreased 1% year-to-date, as the effect of foreign currency translation decreased sales in Japan by 9% and 5%, respectively. Waters sales in the U.S. were flat for the quarter and decreased 3% year-to-date due to lower demand from pharmaceutical customers compared to the third quarter of 2016. Waters sales in the rest of the world decreased 4% in the quarter and increased 2% year-to-date. Both the U.S. and the rest of the world sales were negatively impacted by natural disasters in the third quarter.

*TA Net Sales*

Net sales for TA products and services are as follows for the three and nine months ended September 30, 2017 and October 1, 2016 (dollars in thousands):

|                           | <b>Three Months Ended</b>     |                       |                            |                       |                 |
|---------------------------|-------------------------------|-----------------------|----------------------------|-----------------------|-----------------|
|                           | <b>September 30,<br/>2017</b> | <b>% of<br/>Total</b> | <b>October 1,<br/>2016</b> | <b>% of<br/>Total</b> | <b>% change</b> |
| TA instrument systems     | \$ 44,240                     | 72%                   | \$ 39,524                  | 71%                   | 12%             |
| TA service                | 17,440                        | 28%                   | 16,393                     | 29%                   | 6%              |
| <b>Total TA net sales</b> | <b>\$ 61,680</b>              | <b>100%</b>           | <b>\$ 55,917</b>           | <b>100%</b>           | <b>10%</b>      |

|                       | Nine Months Ended     |               |                    |               |          |
|-----------------------|-----------------------|---------------|--------------------|---------------|----------|
|                       | September 30,<br>2017 | % of<br>Total | October 1,<br>2016 | % of<br>Total | % change |
| TA instrument systems | \$ 126,310            | 71%           | \$ 115,433         | 70%           | 9%       |
| TA service            | 50,383                | 29%           | 49,366             | 30%           | 2%       |
| Total TA net sales    | \$ 176,693            | 100%          | \$ 164,799         | 100%          | 7%       |

The increase in TA instrument system sales for the third quarter of 2017 was primarily driven by thermal growth being fueled by continued acceptance of the recently introduced Discovery product line, while rheology saw strong performance across the entire range of products in the portfolio. Recent acquisitions increased TA sales by 3% and 2% for the quarter and year-to-date, respectively. The effect of foreign currency translation increased TA sales in 2017 by 1% for the quarter and had a minimal impact year-to-date.

Geographically, TA sales in Asia in 2017 increased 19% and 13% for the quarter and year-to-date, respectively. TA sales in China increased 16% and 11% for the quarter and year-to-date, respectively. TA sales in Japan decreased 1% and 4% for the quarter and year-to-date, respectively, as the effect of foreign currency translation decreased TA Japan sales by 8% and 2%, respectively. TA sales in the U.S. increased 10% and 3% for the quarter and year-to-date, respectively. TA sales in Europe increased 11% for both the quarter and year-to-date, with the effects of foreign currency translation increasing European sales by 5% for the quarter and reducing European sales by 1% year-to-date. TA sales to the rest of the world decreased 32% and 12% for the quarter and year-to-date, respectively.

#### *Cost of Sales*

For both the 2017 quarter and year-to-date periods, the increase in cost of sales as compared with the 2016 periods was consistent with the increase in sales volume, as well as product mix dynamics. In 2017, the effect of foreign currency translation increased cost of sales by 2% in the quarter and had a minimal impact on year-to-date cost of sales.

Cost of sales are affected by many factors, including, but not limited to, foreign currency translation, product mix, product costs of instrument systems and amortization of software platforms. At current foreign currency exchange rates, the Company expects that the impact of foreign currency translation may increase sales and still negatively impact gross profit during the rest of 2017, as the foreign currency translation benefit expected from a weaker Euro and Japanese yen would be somewhat mitigated by the unfavorable effect of a stronger British pound on the Company's U.K. manufacturing costs.

#### *Selling and Administrative Expenses*

In 2017, selling and administrative expenses increased 9% and 3% for the quarter and year-to-date, respectively. Overall, this change is attributable to the cost of headcount additions, higher merit compensation costs, severance incurred in connection with the closure of a facility in Germany and an early retirement transition incentive program. The Company incurred \$1 million and \$12 million of severance-related costs in the 2017 quarter and year-to-date, respectively. In addition, selling and administrative expenses included a \$4 million and \$7 million expense related to the acceleration of certain stock awards in the third quarter of 2017 and first quarter of 2016, respectively. The effect of foreign currency translation increased selling and administrative expenses by 2% in the quarter and decreased selling and administrative expenses by 1% year-to-date.

As a percentage of net sales, selling and administrative expenses were 23.9% and 24.4% for the 2017 quarter and year-to-date, respectively, and 23.5% and 24.9% for the 2016 quarter and year-to-date, respectively.

*Research and Development Expenses*

Research and development expenses in 2017 increased 11% and 5% for the quarter and year-to-date, respectively, due to an increase in additional headcount, merit compensation and costs associated with new products and the development of new technology initiatives. Year-to-date, these increases were partially offset by the favorable effect of foreign currency translation, which decreased the Company's U.K.-based research and development expenses by 5% from the weakening of the British pound.

*Litigation Provisions*

During the first nine months of 2017, the Company incurred a \$10 million litigation provision related to the issuance of a verdict in a German patent litigation case.

*Acquired In-Process Research and Development*

During the first nine months of 2017, the Company incurred a \$5 million charge for acquired in-process research and development related to milestone payments associated with a licensing arrangement for certain intellectual property relating to mass spectrometry technologies yet to be commercialized and for which there was no future alternative use as of the acquisition date. The licensing arrangement is significantly related to new, biologically-focused applications, as well as other applications, and requires the Company to make additional future payments of up to \$7 million if certain milestones are achieved, as well as royalties on future net sales. These future payments may be significant and may occur over multiple years.

*Interest Expense, Net*

The decrease in net interest expense in 2017 was primarily attributable to higher income earned on increased cash, cash equivalents and investment balances.

*Provision for Income Taxes*

The four principal jurisdictions in which the Company manufactures are the U.S., Ireland, the U.K. and Singapore, where the Company's marginal effective tax rates were approximately 37.5%, 12.5%, 19.25% and 0%, respectively, as of September 30, 2017. The Company has a contractual tax rate of 0% on qualifying activities in Singapore through March 2021, based upon the achievement of certain contractual milestones, which the Company expects to continue to meet. The current statutory tax rate in Singapore is 17%. For the first nine months of 2017 and 2016, the effect of applying the contractual tax rate rather than the statutory tax rate to income from qualifying activities in Singapore increased the Company's net income by \$18 million and \$16 million, respectively, and increased the Company's net income per diluted share by \$0.23 and \$0.20, respectively.

The Company's effective tax rate is influenced by many significant factors, including, but not limited to, the wide range of income tax rates in jurisdictions in which the Company operates; sales volumes and profit levels in each tax jurisdiction; changes in tax laws, tax rates and policies; the outcome of various ongoing tax audit examinations; and the impact of foreign currency transactions and translation. As a result of variability in these factors, the Company's effective tax rates in the future may not be similar to the effective tax rates for the current or prior years.

The Company's effective tax rate for the quarter was 11.5% and 14.2% for 2017 and 2016, respectively. Year-to-date, the Company's effective tax rate was 10.1% and 12.7% for 2017 and 2016, respectively. The decrease in the effective tax rate in 2017 as compared to 2016 can be primarily attributed to the adoption of new accounting guidance related to stock-based compensation, which decreased income tax expense by \$3 million and \$14 million for the quarter and year-to-date, respectively, and decreased the Company's effective tax rate by 1.7 percentage points and 3.4 percentage points, respectively. See Note 13 for further information regarding the adoption of this standard. In addition, the provision for income tax for the first quarter of 2016 included a quarter-specific tax benefit associated with modifications to certain stock-based compensation awards. The remaining differences between the effective tax rate in 2017 and 2016 can be primarily attributed to differences in the proportionate amounts of pre-tax income recognized in jurisdictions with different effective tax rates.

## Liquidity and Capital Resources

### Condensed Consolidated Statements of Cash Flows (in thousands):

|  | Nine Months Ended  |                 |
|--|--------------------|-----------------|
|  | September 30, 2017 | October 1, 2016 |
| Net income   | \$ 373,483         | \$ 347,125      |
| Depreciation and amortization                                | 78,249             | 72,364          |
| Stock-based compensation                                     | 30,068             | 32,604          |
| Deferred income taxes  | 3,046              | 4,924           |
| Change in accounts receivable                                | 53,358             | 39,471          |
| Change in inventories  | (26,217)           | (39,988)        |
| Change in accounts payable and other current liabilities     | (23,066)           | (29,179)        |
| Change in deferred revenue and customer advances             | 29,332             | 29,244          |
| Other changes  | (12,797)           | 12,452          |
| Net cash provided by operating activities                    | 505,456            | 469,017         |
| Net cash used in investing activities                        | (403,988)          | (438,674)       |
| Net cash used in financing activities                        | (39,494)           | (79,728)        |
| Effect of exchange rate changes on cash and cash equivalents | 36,202             | (8,071)         |
| Increase (decrease) in cash and cash equivalents             | \$ 98,176          | \$ (57,456)     |

### Cash Flow from Operating Activities

Net cash provided by operating activities was \$505 million and \$469 million in the nine months ended September 30, 2017 and October 1, 2016, respectively. The changes within net cash provided by operating activities in the first nine months of 2017 as compared to the first nine months of 2016 include the following significant changes in the sources and uses of net cash provided by operating activities, aside from the changes in net income:

The change in accounts receivable was primarily attributable to timing of payments made by customers and timing of sales. Days sales outstanding decreased to 73 days at September 30, 2017 from 76 days at October 1, 2016.

The change in inventory was primarily attributable to anticipated annual increases in sales volumes, as well as the timing of new product launches.

The change in accounts payable and other current liabilities was a result of timing of payments to vendors, as well as the annual payment of management incentive compensation.



Net cash provided from deferred revenue and customer advances results from annual increases in service contracts as a higher installed base of customers renew annual service contracts.

Other changes were attributable to variation in the timing of various provisions, expenditures, prepaid income taxes and accruals in other current assets, other assets and other liabilities. In addition, as a result of the adoption of a new accounting standard related to stock-based compensation, the Company reclassified \$13 million of excess tax benefits related to stock-based compensation for the first nine months of 2016 from cash flows from financing activities to cash flows from operating activities.

*Cash Used in Investing Activities*

Net cash used in investing activities totaled \$404 million and \$439 million in the first nine months of 2017 and 2016, respectively. Additions to fixed assets and capitalized software were \$55 million and \$72 million year-to-date in 2017 and 2016, respectively. During 2017 and 2016, the Company purchased \$2,345 million and \$1,923 million of investments year-to-date, while \$2,009 million and \$1,558 million of investments matured, respectively.

Cash flow from investing activities year-to-date in 2017 included a \$7 million payment for an investment in a developer of analytical system solutions used to make measurements, predict stability and accelerate product discovery in the routine analytic, process monitoring and quality control release processes for life science and biopharmaceutical markets. In addition, the Company made a \$5 million milestone payment in the first nine months 2017 for acquired in-process research and development for the licensing of certain intellectual property relating to mass spectrometry technologies yet to be commercialized. Business acquisitions, net of cash acquired were \$6 million in the first nine months of 2016.

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*Cash Used in Financing Activities*

During the first nine months of 2017 and 2016, the Company's net debt borrowings increased by \$130 million and \$115 million, respectively. As of September 30, 2017, the Company had a total of \$1,958 million in outstanding debt, which consisted of \$700 million in outstanding senior unsecured notes, \$300 million borrowed under a term loan facility under the Company's credit agreement, \$960 million borrowed under a revolving credit facility under the Company's credit agreement and less than \$1 million borrowed under various other short-term lines of credit, offset by \$3 million of unamortized debt issuance costs. At September 30, 2017, \$125 million of the outstanding portion of the revolving facility was classified as short-term liabilities in the consolidated balance sheet due to the fact that the Company expects to repay this portion of the borrowing under the revolving line of credit within the next twelve months. The remaining \$835 million of the outstanding portion of the revolving facility was classified as long-term liabilities in the consolidated balance sheet, as this portion is not expected to be repaid within the next twelve months. As of September 30, 2017, the Company had a total amount available to borrow under its credit agreement of \$338 million after outstanding letters of credit. As of September 30, 2017, the Company was in compliance with all debt covenants.

In May 2017, the Company's Board of Directors authorized the Company to repurchase up to \$1 billion of its outstanding common stock over a three-year period. During the nine months ended September 30, 2017 and October 1, 2016, the Company repurchased 1.4 million and 1.8 million shares of the Company's outstanding common stock at a cost of \$238 million and \$236 million, respectively, under the May 2017 and other previously announced programs. As of September 30, 2017, the Company had purchased an aggregate of 5.5 million shares at a cost of \$750 million under the May 2014 authorization, which is now completed. The Company has a total of \$885 million in remaining authorized capacity for future repurchases under the May 2017 authorization. In addition, the Company repurchased \$8 million and \$6 million of common stock related to the vesting of restricted stock units during the nine months ended September 30, 2017 and October 1, 2016, respectively.

The Company received \$73 million and \$59 million of proceeds from the exercise of stock options and the purchase of shares pursuant to the Company's employee stock purchase plan in 2017 and 2016, respectively.

The Company had cash, cash equivalents and investments of \$3,255 million as of September 30, 2017. The majority of the Company's cash, cash equivalents and investments are generated from foreign operations, with \$3,212 million held by foreign subsidiaries at September 30, 2017, of which \$337 million were held in currencies other than U.S. dollars. Due to the fact that most of the Company's cash, cash equivalents and investments are held outside of the U.S., the Company must manage and maintain sufficient levels of cash flow in the U.S. to fund operations and capital expenditures, service debt interest, finance potential U.S. acquisitions and continue the authorized stock repurchase program in the U.S. These U.S. cash requirements are managed by the Company's cash flow from U.S. operations and the use of the Company's revolving credit facility.

Management believes, as of the date of this report, that its financial position, particularly in the U.S., along with expected future cash flows from earnings based on historical trends and the ability to raise funds from external sources and the borrowing capacity from existing, committed credit facilities, will be sufficient to service debt and fund working capital and capital spending requirements, authorized share repurchase amounts and potential acquisitions for at least the next twelve months. In addition, there have been no recent significant changes to the Company's financial position, nor are there any anticipated changes, to warrant a material adjustment related to indefinitely reinvested foreign earnings.

**Contractual Obligations, Commercial Commitments, Contingent Liabilities and Dividends**

A summary of the Company's contractual obligations and commercial commitments is included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the U.S. Securities and Exchange

Commission ( SEC ) on February 24, 2017. The Company reviewed its contractual obligations and commercial commitments as of September 30, 2017 and determined that there were no material changes outside the ordinary course of business from the information set forth in the Annual Report on Form 10-K.

From time to time, the Company and its subsidiaries are involved in various litigation matters arising in the ordinary course of business. The Company believes that it has meritorious arguments in its current litigation matters and that any outcome, either individually or in the aggregate, will not be material to the Company's financial position or results of operations.

During the nine months ended September 30, 2017, the Company contributed \$4 million to the Company's U.S. pension plans. During fiscal year 2017, the Company expects to contribute a total of approximately \$6 million to \$11 million to the Company's defined benefit plans.

The Company has not paid any dividends and has no plans, at this time, to pay any dividends in the future.

### **Off-Balance Sheet Arrangements**

The Company has not created, and is not party to, any special-purpose or off-balance sheet entities for the purpose of raising capital, incurring debt or operating parts of its business that are not consolidated (to the extent of the Company's ownership interest therein) into the consolidated financial statements. The Company has not entered into any transactions with unconsolidated entities whereby it has subordinated retained interests, derivative instruments or other contingent arrangements that expose the Company to material continuing risks, contingent liabilities or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the Company.

The Company enters into standard indemnification agreements in its ordinary course of business. Pursuant to these agreements, the Company indemnifies, holds harmless and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally the Company's business partners or customers, in connection with patent, copyright or other intellectual property infringement claims by any third party with respect to its current products, as well as claims relating to property damage or personal injury resulting from the performance of services by the Company or its subcontractors. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. Historically, the Company's costs to defend lawsuits or settle claims relating to such indemnity agreements have been minimal and management accordingly believes the estimated fair value of these agreements is immaterial.

### **Critical Accounting Policies and Estimates**

In the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the SEC on February 24, 2017, the Company's most critical accounting policies and estimates upon which its financial status depends were identified as those relating to revenue recognition, loss provisions on accounts receivable and inventory, valuation of long-lived assets, intangible assets and goodwill, income taxes, uncertain tax positions, warranty, litigation, pension and other postretirement benefit obligations, stock-based compensation, business combinations and asset acquisitions and valuation of contingent consideration. The Company reviewed its policies and determined that those policies remain the Company's most critical accounting policies for the nine months ended September 30, 2017. The Company did not make any changes in those policies during the nine months ended September 30, 2017.

### **New Accounting Pronouncements**

Please refer to Note 13, Recent Accounting Standards Changes and Developments, in the Condensed Notes to Consolidated Financial Statements.

### **Special Note Regarding Forward-Looking Statements**

Certain of the statements in this Quarterly Report on Form 10-Q, including the information incorporated by reference herein, may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), with respect to future results and events, including any statements regarding, among other items, anticipated trends or growth in the Company's business, including, but not limited to, the impact of foreign currency translation on financial results; development of products by acquired businesses; the growth rate of sales and research and development expenses; the

impact of costs associated with developing new technologies and bringing these new technologies to market; the impact of new product launches and the associated costs, such as the amortization expense related to software platforms; geographic sales mix of business; development of products by acquired businesses and the amount of contingent payments to the sellers of an acquired business; anticipated expenses, including interest expense, capitalized software costs and effective tax rates; the impact and outcome of the Company's various ongoing tax audit examinations; the achievement of contractual milestones to preserve foreign tax rates; the impact and outcome of litigation matters; the impact of the loss of intellectual property protection; the

impact of new accounting standards and pronouncements; the adequacy of the Company's supply chain and manufacturing capabilities and facilities; the impact of regulatory compliance; the Company's expected cash flow, borrowing capacity, debt repayment and refinancing; the Company's ability to fund working capital, capital expenditures, service debt, repay outstanding lines of credit, make authorized share repurchases, fund potential acquisitions and pay any adverse litigation or tax audit liabilities, particularly in the U.S.; future impairment charges; the Company's contributions to defined benefit plans; the Company's expectations regarding changes to its financial position; compliance with applicable environmental laws; and the impact of recent acquisitions on sales and earnings.

Many of these statements appear, in particular, under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part I, Item 2 of this Quarterly Report on Form 10-Q. Statements that are not statements of historical fact may be deemed forward-looking statements. You can identify these forward-looking statements by the use of the words "feels", "believes", "anticipates", "plans", "expects", "may", "will", "would", "intends", "appears", "estimates", "projects", "should" and similar expressions, whether in the negative or affirmative. These statements are subject to various risks and uncertainties, many of which are outside the control of the Company, including, and without limitation:

Foreign currency exchange rate fluctuations that could adversely affect translation of the Company's future sales, financial operating results and the condition of its non-U.S. operations, especially when a currency weakens against the U.S. dollar.

Current global economic, sovereign and political conditions and uncertainties, particularly regarding the effect of the U.K. voting to exit the European Union as well as the Chinese government's ongoing tightening of restrictions on procurement by government-funded customers; the Company's ability to access capital and maintain liquidity in volatile market conditions; changes in timing and demand by the Company's customers and various market sectors, particularly if they should reduce capital expenditures or are unable to obtain funding, as in the cases of governmental, academic and research institutions; the effect of mergers and acquisitions on customer demand; and the Company's ability to sustain and enhance service.

Negative industry trends; changes in the competitive landscape as a result of changes in ownership, mergers and continued consolidation among the Company's competitors; introduction of competing products by other companies and loss of market share; pressures on prices from customers or resulting from competition; regulatory, economic and competitive obstacles to new product introductions; lack of acceptance of new products; expansion of our business in developing markets; spending by certain end-markets; ability to obtain alternative sources for components and modules; and the possibility that future sales of new products related to acquisitions, which trigger contingent purchase payments, may exceed the Company's expectations.

Increased regulatory burdens as the Company's business evolves, especially with respect to the Food and Drug Administration and Environmental Protection Agency, among others, as well as regulatory, environmental and logistical obstacles affecting the distribution of the Company's products, completion of purchase order documentation by our customers and ability of customers to obtain letters of credit or other financing alternatives.

Risks associated with lawsuits, particularly involving claims for infringement of patents and other intellectual property rights.

The impact and costs incurred from changes in accounting principles and practices, such as the recently adopted accounting pronouncement regarding employee share-based payment accounting; the impact and costs of changes in statutory or contractual tax rates; shifts in taxable income among jurisdictions with different effective tax rates; and the outcome of and costs associated with ongoing and future tax audit examinations or changes in respective country legislation affecting the Company's effective rates.

Certain of these and other factors are discussed under the heading "Risk Factors" under Part I, Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the SEC on February 24, 2017. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements, whether because of these factors or for other reasons. All forward-looking statements speak only as of the date of this Quarterly Report on Form 10-Q and are expressly qualified in their entirety by the cautionary statements included in this report. Except as required by law, the Company does not assume any obligation to update any forward-looking statements.

**Item 3: *Quantitative and Qualitative Disclosures About Market Risk***

The Company maintains cash balances in various operating accounts in excess of federally insured limits, and in foreign subsidiary accounts in currencies other than the U.S. dollar. As of September 30, 2017 and December 31, 2016, \$3,212 million out of \$3,255 million and \$2,766 million out of \$2,813 million, respectively, of the Company's total cash, cash equivalents and investments were held by foreign subsidiaries and may be subject to material tax effects on distribution to U.S. legal entities. In addition, \$337 million out of \$3,255 million and \$261 million out of \$2,813 million of cash, cash equivalents and investments were held in currencies other than the U.S. dollar at September 30, 2017 and December 31, 2016, respectively.

Assuming a hypothetical adverse change of 10% in year-end exchange rates (a strengthening of the U.S. dollar), the fair market value of the Company's cash, cash equivalents and investments held in currencies other than the U.S. dollar as of September 30, 2017 would decrease by approximately \$34 million, of which the majority would be recorded to foreign currency translation in other comprehensive income within stockholders' equity.

There have been no other material changes in the Company's market risk during the nine months ended September 30, 2017. For information regarding the Company's market risk, refer to Item 7A of Part II of the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the SEC on February 24, 2017.

**Item 4: *Controls and Procedures***

*Evaluation of Disclosure Controls and Procedures*

The Company's chief executive officer and chief financial officer (principal executive and principal financial officers), with the participation of management, evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures were effective as of September 30, 2017 (1) to ensure that information required to be disclosed by the Company, including its consolidated subsidiaries, in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its chief executive officer and chief financial officer, to allow timely decisions regarding the required disclosure and (2) to provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

*Changes in Internal Controls Over Financial Reporting*

No change was identified in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2017 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**Part II: *Other Information***

**Item 1: *Legal Proceedings***

There have been no material changes in the Company's legal proceedings during the three months ended September 30, 2017 as described in Item 3 of Part 1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the SEC on February 24, 2017.



**Item 1A: Risk Factors**

Information regarding risk factors of the Company is set forth under the heading *Risk Factors* under Part I, Item 1A in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the SEC on February 24, 2017. The Company reviewed its risk factors as of September 30, 2017 and determined that there were no material changes from the ones set forth in the Form 10-K. Note, however, the discussion under the subheading

*Special Note Regarding Forward-Looking Statements* in Part I, Item 2 of this Quarterly Report on Form 10-Q. These risks are not the only ones facing the Company. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially adversely affect the Company's business, financial condition and operating results.

**Item 2: Unregistered Sales of Equity Securities and Use of Proceeds***Purchases of Equity Securities by the Issuer*

The following table provides information about purchases by the Company during the three months ended September 30, 2017 of equity securities registered by the Company under the Exchange Act (in thousands, except per share data):

| <b>Period</b>                   | <b>Total Number of Shares Purchased</b> | <b>Average Price Paid per Share</b> | <b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)</b> | <b>Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (1)</b> |
|---------------------------------|---|-------------------------------------|---|---|
| July 2 to July 29, 2017         |   | \$                                  |   | \$ 964,384  |
| July 30 to August 26, 2017      | 230                                     | \$ 178.10                           | 230   | \$ 923,458  |
| August 27 to September 30, 2017 | 208                                     | \$ 187.04                           | 208   | \$ 885,182  |
| Total                           | 438                                     | \$ 182.35                           | 438   | \$ 885,182  |

(1) In May 2017, the Company's Board of Directors authorized the repurchase of up to \$1 billion of its outstanding common stock in open market transactions over a three-year period.

**Item 6: Exhibits**

| <b>Exhibit Number</b> | <b>Description of Document</b>  |
|-----------------------|---|
| 10.1                  | <u>Employment Agreement, dated July 21, 2017, between Waters Corporation and Dr. Rohit Khanna.</u>  |
| 31.1                  | <u>Chief Executive Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>   |
| 31.2                  | <u>Chief Financial Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>   |
| 32.1 *                | <u>Chief Executive Officer Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>  |
| 32.2 *                | <u>Chief Financial Officer Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>  |
| 101                   | The following materials from Waters Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2017, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets (unaudited), (ii) the Consolidated Statements of Operations (unaudited), (iii) the Consolidated Statements of Comprehensive Income (unaudited), (iv) the Consolidated Statements of Cash Flows (unaudited), and (v) Condensed Notes to Consolidated Financial Statements (unaudited). |

\* This exhibit shall not be deemed filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, nor shall it be deemed incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, whether made before or after the date hereof and irrespective of any general incorporation language in any filing, except to the extent the Company specifically incorporates it by reference.

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

WATERS CORPORATION

/s/ SHERRY L. BUCK  
Sherry L. Buck  
*Senior Vice President and  
Chief Financial Officer*

Date: November 3, 2017